

USAID/Croatia



Concept Paper for a

Small/Medium Enterprise Support and Competitiveness Strategy

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Detail of the citadel overlooking the port city of Rijeka

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*Owner and employees of Biogal Ltd.
(Dairy Processor) in Daruvar*



*Restored historic home in Rijeka
exemplifies the town's attractiveness as
a tourism destination.*



Sheep farmer in Djulovac



Monument to National heroes in Rijeka

DISCLAIMER

All opinions expressed in this report are strictly those of the authors, and do not represent the official position of the United States Agency for International Development.

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ABSTRACT

At the request of USAID/Croatia mission, a team of four visited Croatia for two weeks during October 16-27, 2000. The team consisted of Chris Brown (Team Leader), John Godden, Demir Yener (all from the Bureau of Europe and Eurasia/ Office of Market Transition of USAID), and Kevin Murphy of J.E. Austin Associates. The purpose of the visit was to conduct an SME assessment to assist the mission to formulate a Small and Medium Enterprise (SME) strategy that can be incorporated into the overall five-year country strategy.

The resulting document is intended to serve as a concept paper from which a detailed scope of work (SOW) for procurement(s) for SME program implementation can be developed at a later date. The assessment identified impediments, pros and cons to increased private sector investment in SMEs, identify key growth areas and provide specific recommendations to the Mission on exploiting identified opportunities in coordination with other donor programs. It is also hoped that the study will complement the Mission's SME strategy in an effort to accelerate SME expansion in the more dynamic sectors of the economy where there are clear opportunities for growth in employment, income and business investment in both the near and mid term.

Kevin Murphy joined the team, as part of separate activity, under contract with his company, J.E. Austin Associates (JAA), which was to undertake a South East Europe Competitiveness Initiative covering Bulgaria, Romania, Macedonia, Albania and Croatia. The specific objectives of Kevin Murphy's visit to Croatia were to provide inputs for the SME team while beginning the competitiveness initiative in Croatia.

The team looked at the general economic climate, the existing environment for SME development, existing policies, weaknesses and strengths, and entrepreneurship and enterprise development in general in Croatia. The study also looked at possible venues for USAID intervention given the three to five year USAID/Croatia mission objectives. The assessment identified a tripartite strategy for the mission in light of its findings. The central thrust of that strategy should be to enhance Croatia's global competitiveness. To succeed, the strategy will also require technical assistance in two supporting but vital areas: enhancing financial services; and accelerating enterprise development.

These findings were presented to the Mission (Pamela Baldwin, Michael Greene and Damir Novinic) and representatives of the U.S. Embassy Commercial and Economic sections, as well as to E&E/MT Director Bill Frej, on Friday, October 27th in Zagreb.

I. EXECUTIVE SUMMARY

A. Background:

USAID/Zagreb requested a team of private sector experts from the E&E Bureau to conduct an economic assessment of conditions existing for Small and Medium sized enterprise in Croatia. During a two-week visit, 50 meetings were arranged in Zagreb and the surrounding area. Meetings were held with government ministries and support institutions, non-government business support organizations, private sector companies, banks and lending institutions, also representatives of the European donor organizations, existing USAID programs and USG Agencies.



Trg Bona Yalicic (historic square in downtown Zagreb)

The purpose of assessing existing conditions was to formulate an SME strategy as part of a four-year country strategy being designed by the Mission, to provide assistance and to create a sound environment for business development and employment.

The various public and private sector sources the team interviewed during their two weeks of research in Croatia were unanimous in recognizing the importance of small and medium enterprise (SME) as the principal source of job creation and economic growth. Privatization, which may be on the verge of its second, and most aggressive phase after a hiatus of nearly ten years, could aggravate unemployment in the short run. Many of these displaced public sector workers will be relatively well educated and capable of converting to private sector employment or Entrepreneurship with relatively little retraining and support.

The planned USAID strategy will take advantage of current economic liberalization under Croatia's new government, and address important social issues such as unemployment. The new strategy will dovetail with the current two-year-old USAID program, which was designed to assist in the reintegration of displaced people in the war-affected regions of Croatia, and to expand business development and economic opportunities.

The assessment team's findings on the economy focused on three major issues:

- Firstly, that the present economic recovery is fragile because of countrywide high unemployment averaging 22 percent. However, the rate fluctuates between roughly around 10 percent in Zagreb area to 40 percent in regions along the coast. These estimates do not take into consideration the grey economy, which may actually help lower the rate to 15 percent. It is expected that present unemployment rates will rise even higher due to the privatization of 1,900 socially owned businesses, of which 58 are large concerns.
- Secondly, the country's drive towards EU accession within five to six years is a priority of the Croatian government. However, the EU association agreement has

only recently been drafted and the current target date of 2006 may be optimistic. In order to join the EU, the Croatian economy must become more competitive and that will involve reform, restructuring, and the need to complete the privatization of most large public enterprises.

- A third issue of economic concern involves the high income and social taxes (social safety net payments) that businesses must contribute. In addition, the country's burdensome 22% VAT requires that businesses which are already undercapitalized, must pay what is owed within four weeks or be charged an 18% per annum interest penalty. The present high tax rates encourage a large shadow economy that encourages inaccurate business records, and puts undue pressure on businesses that do pay their share of taxes.

B. Recommendations:

USAID/Croatia's private sector strategy should focus on generating employment and investment. The centerpiece of the strategy should be positioning key Croatian industries as leaders in enhancing Croatia's international competitiveness. This central thrust will also require assistance in two supporting, but vital, areas: enhancing financial services and accelerating privatization.

This tripartite strategy is summarized in the recommendations below.

1. Competitiveness Strategy

The team recommends two distinct – but interdependent – thrusts to improve Croatia's competitiveness. They comprise the centerpiece of the proposed strategy. First, Croatia's overall competitiveness approach has to emerge from a public-private dialogue at the highest levels, which USAID would stimulate and then build upon with a selective pattern of technical advisory services. Second, USAID/Croatia could help to strengthen and expand the small/medium business and micro-enterprise communities and the fabric of associations that supports and represents them.

a. Strategic competitiveness initiative:

Preliminary interviews and research indicate that tourism; information technology, textiles, and possibly certain elements of food industries are examples of potentially competitive industry clusters for Croatia. By working with some of these industry groups, in the context of high-level dialogue with government, financial services industry and education leaders, USAID/Croatia could help assure that these industry groups contribute to the fullest extent the lasting employment and earnings opportunities of which they seem capable.

Recommendation: That USAID/Croatia adopt a competitiveness initiative that will include the following key elements and steps:

- Present to 8-10 industry clusters and work with three on the basis of their response to develop strategies and action initiatives including market linkages, information access, technical assistance, workforce development and advocacy.
- Assist Government of Croatia (GOC) Ministry of the Economy and other public and private organizations to publish a Croatian Annual Competitiveness Report along models of similar report published annually by Ireland, but including inputs from private sector clusters.
- Benchmark Croatia's macro- and microeconomic policies, institutions and environment relative to other EU accession countries and the EU itself.
- Provide quality international technical assistance to help leaders of tourism, information technology, textiles, selected food industries, or other promising sectors, to improve standards, expand exports, generate sustainable employment and growth in productivity.

b. Business and Entrepreneurship program:

The pervasive climate of non-payment of business debt, the relative abundance of bank lending liquidity, and the numerous ongoing and planned subsidized credit schemes, argue in favor of USAID avoiding the customary or “mainstream” approaches of direct SME lending or business advisory service delivery. Instead, the team believes that the key to imparting improved Entrepreneurship, marketing, business planning and management accounting skills, would be to challenge the local business advisory/consulting community to develop these basic skills among its clientele, the SME community.

Recommendation: USAID/Croatia could issue a Request for Proposals (RFP) inviting consortia – perhaps led by local consulting firms – to assemble a diverse but manageable group of Croatian and US partners. The RFP scope of work would specify that the successful group must be capable of developing both a basic business training curriculum, and a business/marketing plan for serving as a “wholesaler” of this training. The “retail clients” who would actually offer the training to entrepreneurs would consist of various industry-specific business associations, groups or other institutions who would seek tailored packages of training appropriate to their particular members, constituents, students or clients.

2. Enhanced Financial Services:

Given the prevalence and variety of subsidized credit programs already operating, and their near-universally, disappointing performance, the team determined that USAID's resources could be more productively devoted to addressing the following array of root causes of limited SME access to appropriate credit. The team thus recommends that USAID/Zagreb consider adopting the following recommendations:

a. Encourage SME lending by enabling credit reporting firms to emerge:

Limited, short-term technical assistance could contribute valuable policy analysis to the Central Bank, thus launching the process. This policy analysis would need to persuade the Central Bank to require that all banks report non-payment of debts, no matter how small, to a central database. Credit reference firms could then emerge for the purpose of combining those data with credit information from other sources and offer to banks and individuals a service not presently available here: reliable data on a borrower's credit history.

b. Introduce a variety of non-bank financial institutions and practices:

The following specific business practices and financing approaches are the four best means the team identified of diversifying the range of financial products available to SMEs. They are for USAID to employ, where possible, existing teams, and where none exist, to issue a request for applications (RFA) for an appropriate NGO to:

- Create **industry-specific venture capital funds**;
- Help underwrite the analysis and if necessary, financial guarantees, to help commercial banks and other creditors to establish the practice of honoring grain and agricultural product **warehouse receipts**;
- Similarly, encourage **leasing and factoring** (obtaining credit from a bank, or payment from a buyer, for the discounted value of one's accounts receivable) services;
- Consider the potential to engage USAID's various **loan guarantee** services in favor of banks willing to expand SME lending. As an example, the Development Credit Authority (DCA), could target specific industries such as waste management. The privatization of these municipal functions could be assisted with a combination of loan guarantees through local commercial banks, and technical assistance presently available through the USAID "Balkan Infrastructure Initiative," and
- Explore **micro-finance assistance**, which could be furnished by any of several highly specialized and successful NGOs through an RFA selection process.

3. SME-Related Privatization:

The Government of Croatia, for the last seven months, has been demonstrating relatively strong signs of political will to address relatively difficult aspects of privatization. The first set of major privatization actions since the early 1990s is now being readied. However, two opportunities exist for USAID to help accelerate this relatively slow process:

a. Deconstructing the Agrokombinats:

Today over 40 large, diversified, socially owned agricultural and food companies (agrokombinats) continue to exist, and after a decade of privatization, most are still majority-state-owned. The GOC Privatization Fund Director has asked the team whether USAID could help them to select and engage the agribusiness and corporate restructuring expertise that would effectively identify profitable spin-off enterprises and assist in preparing them for divestment.

Recommendation: That USAID/Croatia select competitively a consortium, firm or NGO qualified to restructure, divest, and help private entrepreneurs launch, successful food processing, production and trading firms derived from the assets of the more promising agrokombinats. The team, working closely with USAID/Croatia's existing Barents advisory team, would also assist the Privatization Fund in liquidating those ill-suited to restructuring or breakup.

b. Privatizing selected municipal waste and water/wastewater services:

Using existing USAID-funded technical assistance teams from the Ecolinks and Local Government projects, explore with USAID-assisted municipal governments the possibility of reducing public outlays and improving public service by privatizing (contracting out), sanitation and water services presently being provided by public entities. These two programs have succeeded in collaborating of their own accord in one instance already. They could probably do so again to great mutual advantage, particularly in Rijeka (coastal tourism/shipbuilding city) and Varazdin (in a war-affected region).

II. Economic Environment for SME Development

A. Economic Prospects and the Environment for SMEs

The recovery of the Croatian economy continues with positive developments. Preliminary estimates suggest that Croatia will achieve GDP growth rates of approximately 4 percent for the next year as a whole. The nascent recovery of the economy was supported by a successful tourist season in summer 2000. This had beneficial effects on the current account deficit and the level of foreign exchange reserves. The Government of Croatia has recently held talks with the IMF regarding a possible stand-by agreement.



Coastal village along the northern Dalmatian Coast.

The central government budget for 2000 is based on expenditure of HRK (Croatian kuna, roughly HRK8.5 =US\$1) 48.3bn (US\$5.7bn) and a deficit of HRK1.3bn (0.8% of GDP). However, the true fiscal stance is much weaker, with the deficit estimated to range around 5-7 percent of GDP. Controlling stakes in leading banks such as Rijecka Banka and Splitska Banka have been sold to foreign investors, following the sales of major stakes in Zagrebacka and Privradna Banks. The government sold 35 percent of its stake in Hrvatske Telekomunikacije to Deutsche Telecom. Croatia joined the WTO in July of this year. The following sections will provide a brief discussion of the general economic environment and its implications on the SME development.

Domestic economy:

The growth of the European and US economies are expected to help Croatia's growth, since the country derives around half of its export receipts from EU markets. The recent political changes in Yugoslavia will lead to more stability in the region, thereby raising the prospects for Croatia. This should especially help the tourism sector.

Exhibit 1. Forecast Summary of Main Economic Indicators

(% unless otherwise indicated)

	1997	1998(a)	1999(b)	2000(c)	2001(c)
Real GDP growth	6.8	2.5	-0.3	2.7	4.0
Industrial production growth		3.7	-1.4	2.5	5.0
Unemployment rate (av)	17.5	17.6	19.4(a)	21.1	20.5
Average Consumer price inflation	3.6	5.7	4.2(a)	5.0	4.0
Exports of goods fob (US\$ m)	4,210	4,605	4,371(a)	4,300	4,950
Imports of goods fob (US\$ m)	9,435	8,773	7,672	7,600	8,480
Current-account balance (US\$ m)	-2,343	-1,550	-1,469(a)	-1,150	-1,240
Current acct. balance as % of GDP	-11.7	-7.1	-7.3	-6.2	-5.9
Total foreign debt (year-end; US\$ bn)	6.8	8.3	8.3	8.5	9.5
Exchange rates (av) HRK per US\$	5.50	6.36	7.11(a)	8.31	7.94

(a) Actual. (b) EIU estimates. (c) EIU forecasts.

Source: EIU, July 2000.

Real GDP rose by 1.6% year on year in the final quarter of 1999, but fell by 0.3% over the year 1999 as a whole. Growth is expected to strengthen in the first quarter of 2000. Unemployment totaled 21.7% at the end of March 2000. The kuna appreciated in earlier 2000. A summary of several main economic indicators is in Exhibit 1 above.

The impact of oil price rises on Croatian inflation will be magnified by the weakness of the Euro, however, as the US economy slows down, Euro will strengthen, helping the value of the Kuna.

Prospects for Economic Growth

Croatia's real GDP rose by 1.6% on a yearly basis in the fourth quarter of 1999, bringing an end to four successive quarters of declining output, however the overall growth rate remained in negative terms for the year as a whole. The forecast for real GDP growth in 2000 is around 2.7%, primarily because there has been an improvement in prospects for both tourism and manufactured goods exports. In 2001 real GDP growth is expected to accelerate to 4% as domestic demand recovers. A breakdown of the GDP by sectors shown in Exhibit 2.

Exhibit 2: Origins of GDP by Sector in Croatia 1999

(Percent of Total)

Agriculture and forestry	8.9
Fishing	0.2
Manufacturing	20.8
Power: Electricity, gas and water	4.0
Construction	7.1
Wholesale retail trade	12.0
Hotels and restaurants	3.1
Transport, storage and communication	9.6
Financial Intermediation	4.9
Real Estate and Renting	11.0
Public Administration and defense	10.7
Education	4.4
Health and Social Work	4.9
Other community and social activities	2.5
GDP at factor cost	100.0

Source: World Bank, EIU September 2000

After the revival in private consumption lead growth in the fourth quarter of 1999, further moderate private consumption growth in 2000, of around 2%, is expected, even though real wage growth is slowing. Consumer confidence was boosted by the election, and the rate of depreciation of the kuna has slowed, leaving the large number of people with currency-indexed loans better off than they would otherwise have been. However, the other components of domestic demand are likely to fall or post low growth rates. Croatia was one of the better performers in terms of GDP growth in the CEE region (Exhibit 3).

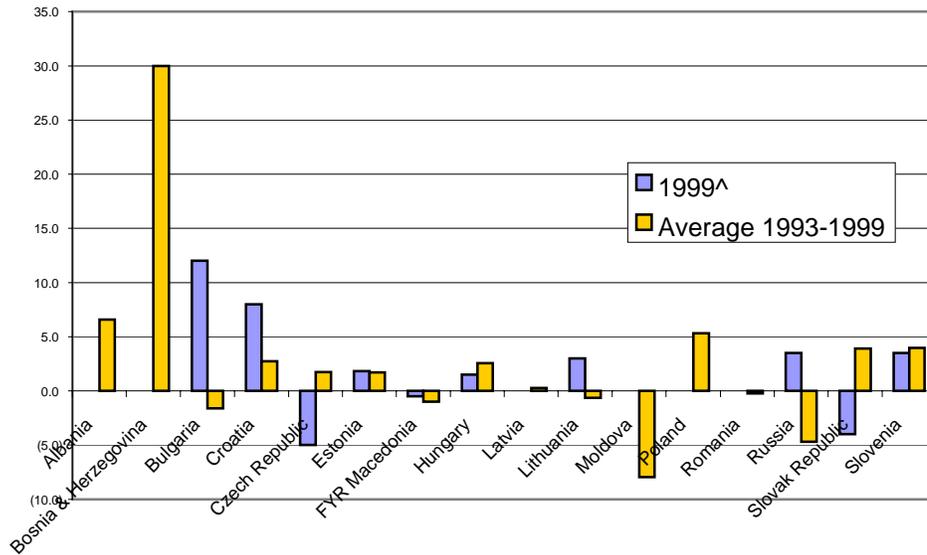
Exports are expected to grow faster in 2001. Given its new membership in WTO, Croatia is expected to also gain customs-free access to the EU in mid-2001 as a result of its EU accession

process. However, this will not result in immediate across the board customs free access to EU markets, but a gradual lowering of tariffs).

Inflation

As a result of the rise in international oil prices and domestic transport costs, inflation is expected to rise to 5 percent in 2000. The strength of the dollar implies higher prices in kuna terms of all internationally traded commodities. Inflation will probably fall to 4 percent in 2001, as the government is expected to lower the rate of VAT.

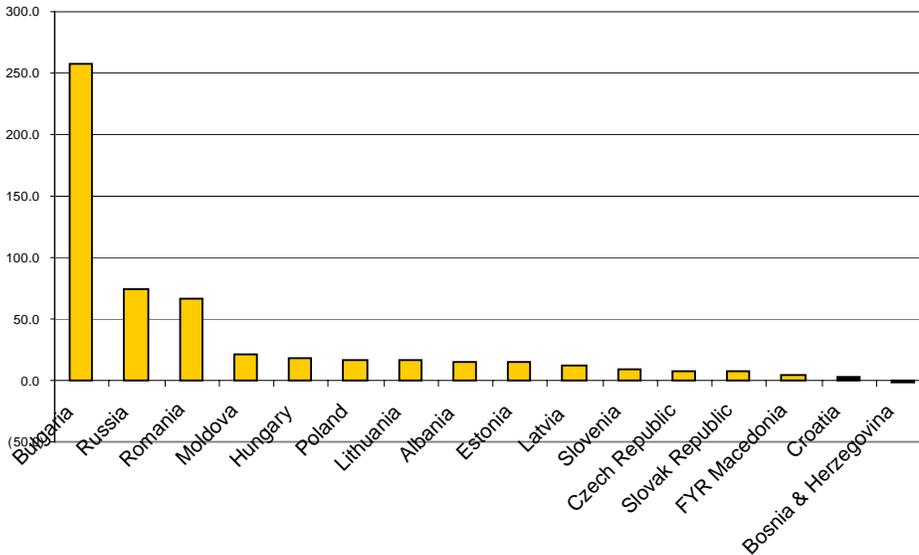
Exhibit 3: GDP Growth 1993-1999



Source: Yener, *A Study of Ten Years of Transition*, February 2000

Retail price inflation has already risen to 4.9% per year in the first four months of 2000. The inflation rate could rise even higher if the central bank can not maintain price and exchange rate stability. There is concern that the inflation will cause higher wage expectations, leading to further inflationary pressures. In relative terms, Croatia compares favorably among its neighbors in the region relative to inflation (Exhibit 4).

Exhibit 4: Average Inflation in CEE Countries (1995-1999)



Source: Yener, A Study of Ten Years of Transition, February 2000

Exchange rates

As exports and capital inflows strengthened, the kuna stabilized. However, the currency now stands at around 8.91 kuna (HRK) per US\$. Strong capital inflows and revenue from tourism should keep the kuna relatively stable in the near term and avert further depreciation until the last two or three months of 2000. The exchange rate is forecast to range at an annual rate of around HRK4.05 per DM1 in 2001. According to EIU, the international reserves of the Croatian National Bank (CNB) totaled over US\$ 3.6 billion at the beginning of November 2000.

Interest Rates:

Interest rates remain relatively high, as compared with countries with economic stability, causing high cost of capital. From 1998 through the second quarter of 2000, interest rates were as follows:

	<i>Interest Rates in Percent</i>		
	<u>1998</u>	<u>1999</u>	<u>Q2-2000</u>
Money Market Interest Rate	14.5	12.4	10.9
Commercial Lending Rate	15.8	13.4	13.6
Deposit Rate	4.2	4.3	4.2

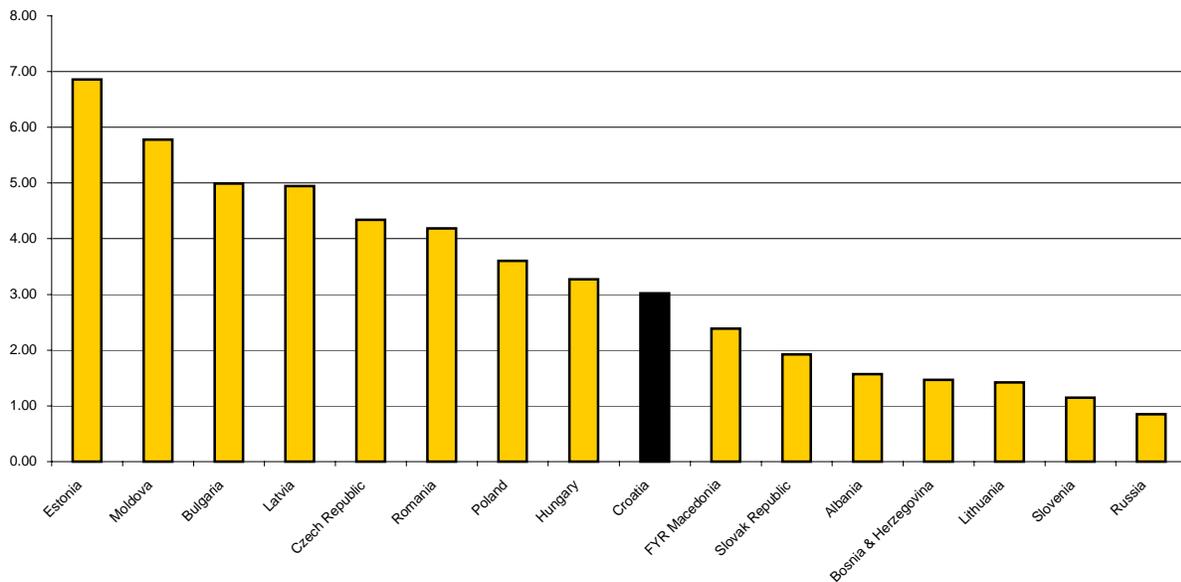
External sector

The current account deficit is expected to narrow in 2000 in both absolute and relative terms to US\$1.15bn (6.2% of GDP). In 2001 stronger domestic demand is expected to lead to a wider trade deficit of around US\$3.5bn, and therefore to a wider current-account deficit of US\$1.24bn. In relative terms, however, the deficit will fall to the equivalent of 5.9% of GDP. Tourism performed well in the summer of 2000, producing receipts of approximately US\$3bn. This was a good year for tourism sector even though hotels have operated at only 60 percent of their capacity on an annualized basis. This compares with the levels reached in 1998.

Capital inflows

According to the Croatian National Bank (CNB), net foreign direct investment (FDI) in the fourth quarter of 1999 totaled US\$929m, which was almost entirely accounted for by the US\$850m proceeds from the 35 percent privatization of the telecommunications operator. Net FDI for 1999 as whole was US\$1.3bn, compared with US\$780m in 1998. As a percent of GDP, compared to the others in the CEE Region, Croatia ranks in the 9th place among 16 countries in attracting FDI between 1997-1999 period (Exhibit 5).

Exhibit 5: FDI As a Percentage of GDP (1997-1999)



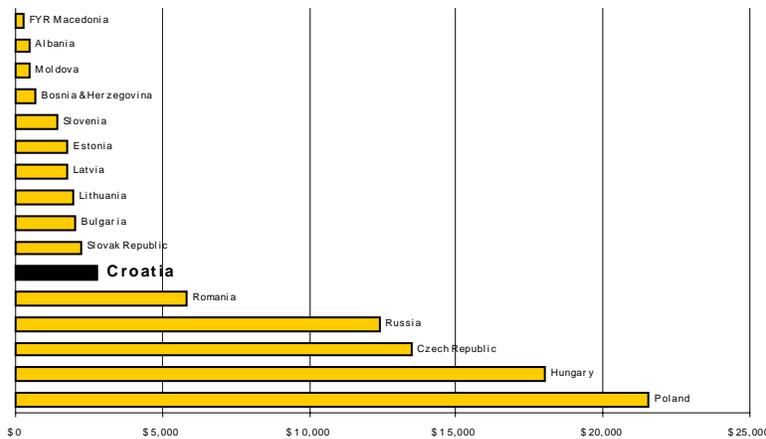
Source: *Demir Yener: A Study of Ten Years of Transition, February 2000.*

Capital inflows have remained strong in the first quarter of 2000, with FDI including the US\$295m proceeds from the privatization of Privredna Banka-Zagreb. In March the government launched a Eurobond issue raising US\$420m with a five-year issue that was priced to yield 2.1

percent over German government bonds. This signals that sovereign risk perception is improving following the political changes.

FDI in the second quarter includes the proceeds of the privatization of two regional banks -- Rijecka Banka and Splitska Banka -- which together raised around US\$90m. Croatia attracted some \$4billion of foreign investments in last six years (1994-2000), but large majority of them are portfolio investments as result of privatization process. Greenfield investment for that whole period was less than 25% of total FDI). In terms of the total amount of FDI attracted, Croatia has done quite well as compared to its neighbors in the region over the period of 5 years during 1993-1998 (Exhibit 6).

Exhibit 6: Cumulative FDI Flows 1993-1998



Source: Yener, A Study of Ten Years of Transition, February 2000

Although Croatia has the benefits of the changed political image, international investors are still very few and far in between on the economic area. This is attributed primarily due to the lack of greenfield and foreign direct investment other than a few sectors. Grants and credits for restructuring and reconstruction are still lacking. The long run growth prospects will be very small or non-existent unless investments provide a rate of return.

Most of the prospects for growth are based on the assumption of attracting FDI. This will not be an easy task, mainly because most of the multinational corporations have already positioned themselves in the region, and the competition to attract them to the region is very stiff. Thus, attracting FDI is a tough challenge for Croatia at this time, which will have implications on the SME sector as well.

Seeking Reductions in Public Expenditures

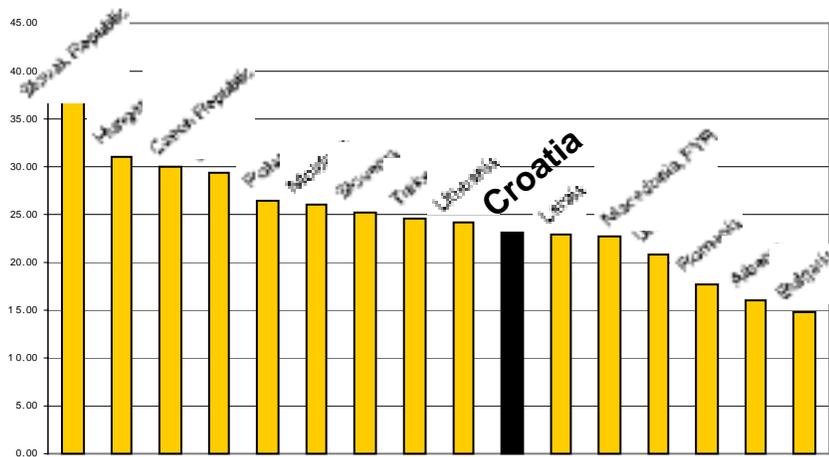
The government's economic policy hinges on a strategy of reducing public expenditure to allow for tax cuts. The Government hopes that this will encourage consumer spending and stimulate the business environment, boosting investment and job creation. Due to the tightening of fiscal policy, a 1.5% decline in government consumption is expected. Although private-sector

investment will probably rise in 2000, the budgetary tightening will involve sharp cuts in public-sector capital expenditure, so that gross fixed investment is forecast to rise by only 0.5% over the previous year. In comparison to the other countries in the region, domestic investment as a percent of GDP sits on the lower end of the scale for Croatia (Exhibit 7).

The government incorporated some of these long-term goals into its 2000 budget, in which central state expenditure was set at HRK48.3bn (US\$5.7bn, or 31.2% of GDP). This represented a nominal reduction of 1.2% over the previous year, but taking inflation into account, and the fact that some of the expenditure will be used to pay off arrears, the true reduction was much greater.

The Ministry of Finance is negotiating a stand-by agreement with the IMF for an 18-month arrangement, probably for US\$250m, possibly to be used as a precautionary measure. The MoF hopes that the stand-by facility will be finalized by the end of the year 2000. However, there are the lingering questions of whether fiscal policy is tight enough, and whether the budgetary targets are realistic.

Exhibit 7: Gross Domestic Investment as Percent of GDP in 1999



Source: Yener, A Study of Ten Years of Transition, February 2000

Employment

The unemployment rate continued to rise in the first three months of 2000, reaching 21.7% at the end of March. Due to the nature of its economic structure and the highly skilled workforce required to maintain it, manufacturing, trades and hospitality (hotels and restaurants) are the main sectors in which unemployment is the largest (Exhibit 8).

Exhibit 8: Unemployment in Representative Sectors
(Figures in %)

SECTORS/YEAR	1995	1996	1997	1998
1. Agriculture	3.3	3.3	3.2	3.1
2. Manufacturing and Mining	20.5	19.6	20.0	19.7
3. Civil Works	5.4	5.4	5.8	6.3
4. Trade	8.0	9.5	11.0	12.1
5. Hotels and Restaurants	8.9	9.6	10.5	10.8
6. Transport and Communications	3.3	3.4	3.9	3.5
7. Banking	1.5	1.5	0.5	0.6
8. Education	2.1	2.1	1.3	1.5
9. Health and Social Care	2.2	2.2	1.8	1.8
10. Unemployed Women	50.5	50.1	50.8	52.5

Source: Croatia Statistical Yearbook 1997, 1998 and 1999.

The average number and the structure of unemployment is equally distributed among the high and low skilled labor force (Exhibit 9). Given the current degree of economic activity, the unemployment figures may rise slightly higher.

Exhibit 9: Educational Structure of the Unemployed in Croatia

STRUCTURE/YEAR	1995	1996	1997	1998	1999	VII/2000
I. TOTAL NUMBER OF UNEMPLOYED	240,601	261,022	277,691	287,762	335,881	346,958
II. STRUCTURE OF UNEMPLOYMENT (%)	100.0	100.0	100.0	100.0	100.0	100.0
Total						
1. College Education	6.9	6.7	6.6	6.6	6.9	7.4
2. High-School Education	22.7	22.5	22.7	23.3	24.2	23.7
3. High-Qualified and Qualified Workers	34.2	35.0	34.5	34.1	35.1	34.5
4. Without Qualification	36.3	35.8	36.3	36.0	33.8	34.4

Source: Croatia Statistical Yearbook 1998 and 1999. Monthly Statistical Report Dec. 1999. and Aug. 2000.

Exhibits 10 and 11 provide some structural characteristics of employment in Croatia in legal entities and crafts. These numbers show that Croatia has a very high degree of skilled work force employed by SMEs sector, which is also reflected in the unemployment figures.

Exhibit 10: Employment in Legal Entities, Crafts and Free Occupations
(Figures in 000 and %)

Y E A R	1995		1996		1997		1998		1999	
	No.	%								
1. Legal Entities	1,196	87.6	1,195	86.7	1,187	86.1	1,272	86.4	1,058	83.8
2. Craft and Free Occupations	169	12.6	183	13.2	192	13.9	201	13.7	205	16.3
3. Total	1,365	100.0	1,378	100.0	1,379	100.0	1,473	100.0	1,263	100.0

Source: Croatia Statistical Yearbook 1999, and Monthly Statistical Report Aug. 2000.

Exhibit 11: Age, Gender and Structural Characteristics of Employment in Croatia
(Figures in %)

STRUCTURE/YEAR	1996.	1997.	1998.	1999.
I. TYPE OF EDUCATION	100.0	100.0	100.0	100.0
1. College Education	20.1	20.8	21.1	21.5
2. High-School Education	30.8	32.1	34.4	35.7
3. High-Qualified Workers	4.9	4.5	4.2	4.0
4. Qualified Workers	20.8	20.0	18.9	18.2
5. Without Qualification	23.4	22.5	21.4	20.7
II. TYPE OF EMPLOYMENT	100.0	100.0	100.0	100.0
1. Full-Time Employment	98.7	98.5	98.5	98.5
2. Part-Time Employment	1.3	1.5	1.5	1.5
III. AGE AND GENDER	100.0	100.0	100.0	100.0
0-19	0.6	0.6	0.5	0.7
19-24	6.2	6.4	7.1	6.8
25-29	10.7	10.6	11.1	11.2
30-34	15.4	15.2	14.7	14.5
35-39	18.6	18.2	17.8	17.4
40-44	18.7	18.6	18.1	18.0
45-49	15.5	15.6	15.6	15.9
50-54	8.8	9.0	9.2	9.8
55-59	4.4	4.6	4.6	4.4
60-64	1.0	1.1	1.2	1.2
65 and more	0.1	0.2	0.15	0.2
IV. WOMEN IN TOTAL	47.2	47.5	47.3	47.0

Source: Statistical Yearbook 1998, 1999, and June 2000

Croatian employment figures indicate that there has been a steady increase in the numbers of people employed in crafts and free occupations, meaning private sector employment is rising. Exhibit 12 provides a break down of employment by size of business.

Exhibit 12: Universe of Enterprises in Croatia and the Distribution of Employment
(by size in legal entities only)

STRUCTURE	Y E A R		1997		1998		1999	
	No.	%	No.	%	No.	%	No.	%
I. Corporate sector - Total								
1. Number of Corporations	64,789	100.0	62,050	100.0	59,972	100.0		
2. Employment	772,085	100.0	762,378	100.0	749,642	100.0		
II. Large Enterprise								
1. Number of Corporations	558	0.9	548	0.9	574	1.0		
2. Employment	359,152	46.5	340,306	44.6	329,457	44.0		
III. Small Enterprises								
1. Number of Corporations	62,501	96.5	59,718	96.2	57,323	95.6		
2. Employment	231,421	30.0	241,408	31.7	252,987	33.8		
IV. Medium Size Enterprises								
1. Number of Corporations	1,730	2.7	1,784	2.9	2,075	3.5		
2. Employment	181,512	23.5	180,664	23.7	167,198	22.3		
V. Crafts and Artisans - Total	185,768	-	186,795	-	-	-		
1. Number of Craftpersons	84,912	-	80,460	-	-	-		
2. Employment	100,856	-	106,335	-	-	-		
VI. Free Occupations – Self-employment	11,096	-	13,686	-	-	-		

Source: ZAP, October 2000.

Overall, employment has been increasing after a long period of decline. Wage increases have moderated. However, in real terms, there has been practically no change in the average net wage since the last quarter of 1999, while average monthly gross wages have dropped by 3 percent to around US\$500

This drop in average wages was due to the tax wedge between the labor cost to employers and the take home pay for employees. The tax “wedge” in Croatia still remains relatively large. For a single person, without children, the tax wedge is 41 percent of the gross monthly wage. This issue has some implications on the competitiveness of the country as a whole, but more so on the SME sector. Even though a study by the Economics Institute of Zagreb indicates that there has been a small decrease in average gross wages, mostly in public sectors due to collective wage agreements, there have been increases in business wages. This is attributed to the reported wage increases in these sectors especially in public and state owned enterprises.

Industrial output accelerates

In the first quarter of 2000 gross industrial output grew by 3.7% over the past year. Manufacturing sector led the way, registering a year- on-year expansion of 4.3%. The depth of the recession in manufacturing occurred in the fourth quarter of 1998 and first quarter of 1999 — and it is therefore no surprise that there has been growth relative to these low points of comparison.

Manufacturing sector showed the largest improvement in segments that were hit the hardest in the recession. Chemicals sector enjoyed an output growth of 25.7%. Similarly, a 7.3% per year increase in output of machinery and equipment reflected the fact that this sector had been one of the worst affected. Output of "other transport equipment", the bulk of which is accounted for by the country's six major shipyards, fell by 2.3% in the first quarter, reversing a pattern of two years of strong growth.

Foreign Trade

Exports rose sharply in the first three months of 2000, and Croatia recorded its best export performance since mid-1998. Export receipts totaled US\$1.1bn, which in nominal dollar terms represented an increase of 13.5% per year. Exports to the main trading partners of Croatia in EU rose by 13.6% over the year, accounting for around half of the absolute expansion in dollar exports in the first quarter.

Imports fell in dollar terms by 1.4% over the past year to US\$1.63bn in the first three months of 2000, despite higher oil prices. Similar to the final quarter of 1999, imports of mineral fuels grew by 41.7% year on year, reflecting a combination of rising oil prices and an expansion in imported oil volumes (1st quarter 2000), while non-oil imports declined in dollar terms. The true level of imports, however, may in fact probably be rising, not falling if the new accounting rules are factored in.

Data for 1999 shows that transportation equipment (shipping parts); Chemicals and apparel exports were the leading items of foreign trade activity. Oil, is the third largest item on the

import list, following transport equipment and machinery and equipment. Exhibit 13 provides a detailed look at the composition of foreign trade by sector.

Exhibit 13: Composition of Foreign Trade by Sector in Croatia 1999

<i>Foreign Trade by Sector</i>	EXPORTS (FOB)	IMPORTS (CIF)
Transport Equipment	795	1,311
Chemicals	491	902
Ready made garments, apparel	456	-
Food Product and beverages	334	473
Coke, petroleum & nuke fuels	320	701
Electrical Equipment	285	611
Timber and Wood products	204	-
Leather goods	185	-
Metals products	-	608
Machinery and Equipment	-	778
Agricultural Products	-	222
TOTAL Including Others	4,280	7,777

Source: Croatian Central Bureau of Statistics, June 2000.

Croatia has recently signed Free Trade Agreements (FTAs) with Slovenia and Macedonia, and is expected to sign one with Bosnia and Herzegovina in November as part of the Zagreb Summit decisions. Additionally, the Croatian Government is currently negotiating bilateral trade agreements with several countries, such as CEFTA with Hungary and Slovakia, and other significant trading partners such as Turkey, to sign the FTAs. According to Minister of Economy, Mr. Goranko Fizulic, signing of FTAs with as many as possible countries is one of the highest priorities for Croatia, and in his opinion within the next few years, Croatia will have more than 50% of its exports to those markets.

Fundamentals surrounding the current-account deficit

Following three successive quarters of improving external balances, Croatia recorded a surprisingly large current-account deficit of US\$764m in the fourth quarter of 1999. This was 17.4% higher than the deficit in the final quarter of 1998 even though the trade deficit, at US\$972m, was 8.5% below its year-earlier level. The improvement in the trade deficit was outweighed by deterioration in all other components of the current account.

The proceeds from bank privatization and a Eurobond issue have underpinned a strengthening in capital inflows. Given the consolidations taking place and foreign direct investors coming in to the banking sector, Croatia is slowly beginning to restructure its economy into a market-oriented system in which cost of production is rationalized.

However, several structural shifts appear to be under way, including a decline in receipts from transport. The 1998 surplus of around US\$55m from transport sector fell below US\$20m, while in the fourth quarter it was just US\$3.8m in 1999. One possible explanation for this development is the severe difficulties faced by the Croatian shipping industry in 1999, which resulted in the collapse of one large firm, Croatia Line.

Over 1999 as a whole, the current-account deficit totaled US\$1.47bn (7.3% of GDP), which was its lowest level in absolute terms since 1996. A second reason to expect a narrowing of the deficit in 2000 is the weakness of the Euro, in which most items of the balance of payments are denominated. A caveat is to assure investors and creditors that the deficit will not go any higher. One of the reasons for the high level of interest rates in Croatia is the demand for capital, and the monetary policies of the government to keep the value of the currency stable. However, this may lead to the overvaluation of the currency, and thus lack of creditworthy customers in a high cost of capital business environment.

B. Environment for and the Characteristics of SMEs in Croatia

The significant role that SMEs can play as an engine for economic growth of Croatia has been well understood and appreciated by all parties. In general, however, legal and regulatory environment is not too conducive for free business enterprise to flourish. At this time, this has been well understood by the policy makers, and efforts are underway to resolve the situation. SME development is considered as a national high priority item on the political and social agenda.

The stabilization of the macro economic environment was the main priority not too long ago. Major issues problems related to privatization and restructuring has directed the attention of policy makers, among other issues, towards policies and strategies oriented towards the rapid development of the enabling environment for SMEs.

A through analysis of the SME development in Croatia has to take into consideration the specific circumstances that the country went through especially during the war time period of 1991-1995. Drastic changes have taken place in the economic and social structure of the country as a result of the profound implications of the war, leading to the further emphasis on the development of private sector and SMEs.

Croatia exhibits the typical trends for a transitional country as evident from the data presented. The bullet point review of the data below in Exhibit 14 shows the number of new enterprises established, their size, structural changes in employment and efficiency.

- The number of enterprises established grew to 60,000 legal entities in the corporate sector, and topped off at that level. Most of them are small enterprises.
- A more important fact is that the employment in small enterprises has been growing steadily while there is a dramatic drop in employment in large enterprises.
- Self-employment has been getting more importance.
- The value of assets has been decreasing in large enterprises due to the high degree of "financial leverage", Large enterprises find easier access to debt capital than could small enterprises, and thus the excessive leverage and the inherent weakness of the enterprise sector in Croatia. This also has profound implications on the growth of capital markets.

- Although large enterprises own over 54% (1999) of the real sector assets, they generate lower profits before taxes (44.8%; 1990) and larger losses (55.3%; 1990) than SMEs. This is also the testimony that SMEs can be more efficient in allocating resources than the SMEs, and thus relatively more profitable.
- The restructuring process calls for reallocation of labor, which is illustrated by growing employment in crafts and free occupations in comparison with all other legal entities (large, small and medium size enterprises).
- According to the structural characteristics of employment, one may conclude that there is an unfavourable trend towards decreasing the share of highly qualified and qualified workers, and the growing share of those who are high school educated. This means that the pre-qualification and re-training is a major necessity in the process of restructuring the labor force.
- The current high rate of unemployment is the most difficult problem in the Croatian economy. Most of the unemployed are highly skilled and qualified workers and equal number which are considered low skilled.
- Among representative groups of activities manufacturing and mining lead in unemployment, which is the result of technological obsolescence of machinery and equipment lack of know-how to be more competitive on a global scale.

Exhibit 14: Asset Structure, Corporate Financing and Efficiency of SMEs in Croatia
(end of the year figures)

Y E A R	1996		1997		1998		1999	
	mill kunas	%	mill kunas	%	mill kunas	%	mill kunas	%
1. Assets - Total	325,493	100.0	350,735	100.0	372,721	100.0	412,106	100.0
1.1. Large Enterprises	193,454	59.4	194,689	55.5	201,646	54.1	235,000	57.0
1.2. Small Enterprises	63,379	19.5	80,730	23.0	87,462	23.5	99,159	24.2
1.3. Medium Size Enterprises	68,660	21.1	75,316	21.5	83,613	22.4	77,947	18.9
2. Equity and Reserves	197,349	100.0	178,862	100.0	180,660	100.0	199,927	100.0
2.1. Large Enterprises	136,454	69.1	116,536	65.2	116,937	64.7	138,062	69.1
2.2. Small Enterprises	21,424	10.9	23,654	13.2	24,472	13.5	26,770	13.4
2.3. Medium Size Enterprises	39,471	20.0	38,672	21.6	39,251	21.7	35,095	17.6
3. Total Revenue	231,663	100.0	279,349	100.0	266,115	100.0	273,900	100.0
2.1. Large Enterprises	102,992	44.5	117,848	42.2	113,590	42.7	122,165	44.6
2.2. Small Enterprises	83,742	36.2	100,344	35.9	91,595	34.4	95,227	34.8
2.3. Medium Size Enterprises	44,929	19.4	61,157	21.9	60,930	22.9	56,508	20.6
4. Profit Before taxes	7,719	100.0	10,578	100.0	9,174	100.0	10,704	100.0
2.1. Large Enterprises	3,139	40.7	4,702	44.5	3,598	39.2	4,792	44.8
2.2. Small Enterprises	3,312	42.9	3,726	35.2	3,677	40.1	4,005	37.4
2.3. Medium Size Enterprises	1,268	16.4	2,150	20.3	1,899	20.7	1,907	17.8
5. Losses	11,427	100.0	9,637	100.0	11,790	100.0	15,030	100.0
2.1. Large Enterprises	7,081	62.0	4,702	48.8	6,220	52.8	8,303	55.2
2.2. Small Enterprises	1,727	15.1	2,090	21.7	2,486	21.1	3,536	23.5
2.3. Medium Size Enterprises	2,619	22.9	2,845	29.5	3,084	26.2	3,191	21.2

Source: ZAP, September 2000.

The interesting aspect of Exhibit 14 is that in terms of corporate profitability, larger firms turn out higher rates of pre-tax profits as compared to SMEs. However, SMEs achieve relatively lower loss rates than the larger firms. Patterns of corporate finance show that there is excessive use of leverage throughout the corporate sector. This indicates that smaller business make more efficient use of debt and equity capital. It must be noted that general business conditions will also affect the outcome of corporate performance and underlying corporate fundamentals will have a profound impact on the outcome of operational policies.

In sum, Croatian enterprise sector as a whole shows risky corporate finance practices which has implications on their ability to lower the overall cost of capital. Qualify for bank loans, to renew existing loans, or have access to risk capital through the stock markets. Unless this is not remedied with an effective financial restructuring program, SME development and financing will be difficult to sustain.

C. Policy Priorities for SMEs in Accordance with EU standards

In light of the above discussions, we propose that the newly established Ministry of Crafts and Small and Medium Enterprise follow the policy recommendation for a timely adjustment of the business environment for the existing and start up SMEs in Croatia:

1. Harmonisation of laws with EU standards.
2. Building the enabling business environment in support of SME development
3. Enhancing the competitiveness of SME.
4. To train entrepreneurs and public sector employees on entrepreneurship.
5. Improvement of financial environment, and access to capital.
6. Promotion of innovation and capacity development to increase efficiency of management in a changing and globalizing business environment
7. Improvement of condition for easier access to the globalized market
8. To attain improved efficiency in networking among entrepreneurs on an international scale
9. Promotion of entrepreneurship with special emphasis on information and knowledge

Box 1:

The Ministry of Crafts and Small and Medium Enterprise

The Ministry harmonizes its activities with other ministries and especially with the Employment Bureau. According to the Program of development of SMEs, County Centres for Entrepreneurship have been established. These centres have direct contact with entrepreneurs. They work locally implementing development policy by establishing Entrepreneurship incubators and free business zones for SMEs.

The Ministry for Craft, Small and Medium Enterprise is responsible for:

- *Crafts/Artisans*
- *Small enterprises*
- *Medium Size enterprises*
- *Co-operatives*

This Ministry was established in February 2000. The importance of SME has been recognized since:

- *there are 88,000 craftsmen in Croatia with 205,000 employed workers*
- *there are 58,000 small and medium size enterprises that employ 400,000 workers*
- *craftsmen and SME make 99.0 of all registered economic subjects, participate with 65.6% in total employment and with 66.2 in total revenue*

Ministry works on problems encountered by SMEs. Some of the recent activities and responsibilities are:

1. *The role of Small Business in the development strategy of Croatia - The Study that is expected to be finished at the end of this year*
2. *Continued work on specific Laws related to SME*
3. *Follow up activities in the scope of the Development program for SME*
4. *International Co-operation*
5. *Education in SME*
6. *Promotion of SME*

III. ENTREPRENEURSHIP AND ENTERPRISE DEVELOPMENT

A. Role of Financial Sector in the Development of SMEs

1. Banking Sector:

The origins of the current Croatian financial sector weakness, especially in the banking area, is rooted in the way the system was set up following the break-up of the former Yugoslavia. Since the establishment of the new banking regime in 1992 by the Central Bank Law and the new Banking law in 1993, despite major improvements in the overall sector, banks have suffered from the following major weaknesses:

- (a) lack of adequate capitalization, distorted accounts;
- (b) flawed governance, interference of debtors and major shareholders in management decisions, as well as social and political pressures on decisions caused major impediments to sound banking practice;
- (c) poor intermediation and lack of management skills for sound bank management;
- (d) inherited regional segmentation of the sector created major vulnerabilities to the effects of the war and the disruptions caused by the transition process.



Outside the modern Gavilovic processed meat factory in Petrija. This family owned maker of popular, high quality sausages and hams has been owned nearly continuously by the same family for over 300 years.

The decisive steps taken by the government in dealing with the financial systems development, with two major interventions — to bail-out the banks through the issuance of bonds and freezing the foreign exchange deposits — helped bring the depositor confidence in the system. These steps, however, also prevented most banks from realizing proper liquidity management, and they had no positive effect on the development of the non-bank financial sector, as an alternate source of finance for the enterprise sector, especially in relationship to the development of SMEs.

As of September 2000, 60 percent of the commercial banks, out of a total of 44 in the system, were privately owned. Despite this, bank intermediation remains severely curtailed by losses accumulated from extended periods of high inflation and misallocation of funds to loss making enterprises. Current reports by the Croatian National Bank (CNB) indicate that 90 percent of the loans are performing as of the end of 1998. However, the consolidation in the sector is continuing, and as of September 2000, the number of banks has declined to 44 from the high of 60 at the end of 1998.

A major impediment to the soundness of the banking sector remains the largely incomplete privatization, and highly indebted enterprise sector as the underlying main factors. Even though a degree of confidence was re-established and banking deposits have been growing steadily during the last 18 months, lending activity, especially business lending activity has been very low. Most banks indicate that they are unable to find creditworthy business customers and now

have the problem of lack of satisfactory intermediation opportunities. Most of the current lending activity is towards retail customers. Partially the more prudent approach of the banks towards lending stems from the stricter regulatory requirements under the supervision of the CNB.

The recent improvements in the banking sector still leaves two important issues unresolved:

- (a) accounting (International Accounting Standards (IAS) and Auditing) and prudential rules need to be further developed and enforced, (such as “*fit and proper*”; “*know your customer*” and “*value at risk*” rules) which is crucial in bringing the banking system in line with the emerging international standards. This will also provide a realistic picture of the banks’ actual financial condition.
- (b) banking supervisory capabilities need to be increased so that stability in the banking sector can be achieved.

The resolution of compliance with IAS and auditing standards required by the banking system will also help in the accelerated conversion of all enterprises eventually to adopt the IAS.

Under these circumstances, risks remain in the banking sector over the short and medium term:

- (a) Vulnerability to macroeconomic developments. Over 90 percent of all lending are indexed to the deutsche mark (DM). It would be difficult for the banking sector to withstand a significant depreciation or devaluation of the kuna. The ability of the new government to manage macroeconomic policy and bring the economy out of recession is critical. There is also the concern that the overvaluation of the kuna is likely to have negative implications on Croatia’s foreign trade prospects.
- (b) Too many small banks: Currently there are 41 banks operating in Croatia. This is down from 60 at the end of 1998. Only 18 of these banks, however, meet the criteria of being “significant banks,” with deposits exceeding 1 percent of the total banking sector assets of approximately US\$17 billion, as per the Bankers Association. Two large banks account for 41 percent of all deposits in the country (Zagrebacka and Privredna Banks). Consolidation in the banking sector has begun with the entry of foreign banks. The large number of small and poorly managed banks in Croatia strains the system. It is possible that many of these banks are insolvent and may fail in the near term. In addition, the ill-designed deposit insurance system has significantly raised the cost of bank failures.
- (c) Weakness of the enterprise sector: the real sector is beset by high degree of leverage, and structural weaknesses, reflecting to a great extent the defective Croatian privatization program which resulted in crony control of much of the countries' enterprises under the previous government. Productive investment and effective corporate governance practice in the real sector has been woefully inadequate. Too much of the economy remains in government hands, spread among the Pension, Health and Privatization funds and the Bank Restructuring Agency. The weak overall

condition of the banking system directly reflects the grim state of the enterprise sector. In terms of performance, Croatian banking sector has not been profitable despite the growing deposits and large spreads required on loans.

- (d) Lack of adequate economic incentive structure: the current incentive structure is not conducive for the development of a sound, dynamic banking sector. This is related in part to the widespread political interference in the economy during the previous regime in which business decisions were not based on commercial criteria but rather on political connections. It is possible to say that corrupt practices had a hand in reaching this point.
- (e) Credit culture: the debt repayment culture does is very weak, and consequences for non-payment of debt is immaterial. The banking sector reports 10 percent of non-performing loans, and this is one of the main reasons for the lack of lending to business. There is an increasing retail credit card and lending activity, as the banks have better control over the non-repayment issue with retail customers than with businesses. The bankruptcy law has not been enforced effectively, contract sanctity is not the norm and collateral cannot be perfected in a timely manner. Banking system is very unlikely to prosper in such an environment.
- (f) The large fiscal costs of bank restructuring: While the general consensus is that the crisis is over, the large fiscal costs associated with the clean up remain. Unfunded deposit insurance liabilities from the banks that failed in 1998-99 total about Kuna K3.2 billion (DM900 million). This represents about 2 percent of GDP at a time of needed fiscal consolidation. Paying these claims needs to be a priority of the new government. If not, it risks undermining public confidence in the system. It should set up a timetable to pay the depositors, stick to that timetable.

Currently, there is high level of liquidity in the financial sector (the ratio of monetary assets to GDP is 41 percent, and the banking sector assets of US\$16.8 billion represent 75 percent of GDP at the end of 1998). The high level of liquidity in the banking sector, while reflecting some degree of restored depositor confidence, has also lead to the proliferation of many new and undercapitalized small banks. The entry of new and undercapitalized banks adds to the further fragility of the banking system, more so than to the sector's capability for diversification of risks and domestic and international competitiveness.

Some of this liquidity could be directed into the SME sector through the creation of an enabling, effective regulatory environment and the legal infrastructure for the formation of NBFIs such as leasing, factoring and credit unions in Croatia. The problem of credit repayment can be effectively dealt with through the formation of independent credit rating agencies.

In conjunction with SME lending, there have been various programs by banks supported by various government agencies and Ministries. A notable program is the one with the Croatian Bank for Reconstruction and Development (HBOR) providing loans for business start-ups and for small enterprises with very favorable rates. While this program is underway, it is clear that

the incentives provided less than satisfactory results for the banks that are involved in the program.

The reasons are again more related to the general macroeconomic environment and the culture of non-repayment of credits by business, without much effective recourse to their credit standing, nor to their access to capital, however high the cost of capital may be. The role of the banking sector is important in the SME development, however, the persistent macro economic and banking sector weaknesses will preclude the banking sector from its delivery of funding for the SMEs for a while until fundamentals become stronger.

In sum, while the banking situation has stabilized and is starting to get back on track, Croatia faces numerous challenges to complete the reform, rehabilitation and restructuring of the banking sector, and to move in the direction of providing intermediation for business lending that it is supposed to be doing.

2. Development of Non-Bank Financial Intermediaries (NBFIs) Sector:

Despite very high interest rates, that range on average 12-13 percent on lending, returns on equity in the banking sector have averaged about 4 percent until 1998 and dropped precipitously following the crisis of 1998, only to slightly improve by the third quarter of 2000. Even though a small number of banks achieved high rates of return this is not sustainable given the current circumstances. Most of this partial improvement may be due to overstatement of the capital structure of a number of banks, linked to the legacy of the previously employed banking standards, leading to the abnormally low level of leverage. This may mean that either the capitals of many banks are overstated, or there is a sign of excess capacity in the banking sector.

Both problems can be corrected through a number of regulatory measures, by creating the appropriate incentives in the financial sector leading to the development of *non-bank financial intermediation* (NBFIs). NBFIs may help reduce the over reliance on the weak banking sector for intermediation. NBFIs may be especially important in channeling financial resources towards the special financial needs of SMEs by helping reduce the very high levels of cost of capital in Croatia for business development.

Other types of financial intermediation is either non-existent or in its very early stages of development in Croatia. The following section takes a brief look at the existing NBFIs in Croatia, and possibilities for their further development, in support of the SME finance.

Savings Associations

There are some 30 savings banks that operate under a still undefined regulatory framework. Even though their significance is very small and restricted only to their membership, CNB has recently introduced some new supervisory oversight measures designed to improve their risk exposure by imposing capital adequacy, accounting and disclosure requirements.

Insurance

The market for insurance industry is not well developed. In a country with a high degree of unemployment, there are 26 insurance companies in Croatia with total premiums turnover of about 4 percent of GDP. These insurance firms are mostly in the property and casualty side of the business, and not too many life insurance products are offered. Given the current economic environment where unemployment is rampant, this can be considered normal. This leaves room for improvement. The state owned Croatia Osiguranje controls about 60 percent of the market alone. The strengthening of this sector as a collective savings institution may provide some further investment opportunities to the financial markets.

Securities Markets

The securities markets infrastructure and regulatory frameworks are in place. The Zagreb Stock Exchange has been in operation since 1991, with its own trading system (MOST) in place. The trading activity is very small, however, and it is concentrated around most active top 10 companies. Even though there are over 700 listed firms, about 65 stocks show trading activity.

The capitalization of the market is around US\$2.4 billion as of September 2000 and is slowly rising. There is also an OTC market with operations in Varazdin since 1995 where most of the 7 PIF shares trade.

The Securities Depository Agency (SDA) has recently been established to handle securities clearing and settlement transactions. SDA also acts as a central registry. Five of the seven PIF share issues are registered with the SDA, and it is expected that by end of 2001, 500 issuers will be registered.

There are currently 53 licensed brokers and dealers, and 5 banks as custodians that participate in the SDA operations. There are 2 closed-ended and 9 open-ended investment funds in existence. There are 18 licensed investment fund management companies.

The ZSE has 89 stocks, 10 preferred equity issues, and 1 corporate bond, 38 deep discount bonds listed. All of the equities are the shares of privatized enterprises, and the sole corporate bond is that of the leading Bank, Zagrebacka Banka.

The low trading volume on the ZSE may be linked to the bad underlying corporate financial fundamentals and their overall lack of competitiveness and viability. Unless privatization is completed, and companies listed as a result of privatization are completely re-structured, the securities market is not likely to achieve the status of repository of savings for investment activities. Otherwise the trading capacity is now sufficient to carry the volume.

The principal problem of the Croatian capital markets is not the lack of market infrastructure, but the non-existence of adequate financial products, and quality instruments (equities, bonds) issued by Croatian issuers. If the liquidity in the banking sector is an indicator of investable funds waiting to be channeled into quality investments, the securities market may attract some

investors if new corporate debt securities are developed by high quality issuers such as Pliva and Zagrebacka Bank. The debt instrument issued by the Zagrebacka Bank and is doing well.

The PIFs are traded in the Varzadin OTC market. The more lax disclosure requirements by the OTC attracts the trading of PIFs in that market. PIFs need to be converted into closed end funds after their life of five years, however no guidelines have been issued so far. Since at the end of their term, PIFs must be converted into the status of a closed end equities funds, and there are a dearth of available quality Croatian securities, markets will be inadequate to build risk-diversified portfolios due to the non-existence of attractive equities. This may force the funds to look to international market for good foreign investments but this will not benefit the development of Croatian capital markets. This will have further implications on using the capital markets for SME financing in the long run.

It appears that liquidity in the Croatian capital markets can be largely increased by introduction of new financial instruments, especially fixed income securities. With the addition of innovative new financial instruments, capital markets will gain additional vibrancy.

In terms of providing the needed financial support for the SMEs, the role of the securities market will be to act as an exit mechanism for venture capital funds which would like to sell out after the nurturing stage their start-ups through IPOs in the marketplace. This is likely to happen once sufficient market trading volume and liquidity is achieved in the ZSE.

Securities regulations

The Croatian Securities and Exchange Commission (CROSEC) has been established to provide prudential regulatory oversight for the development of the securities markets as an outlet for the shares of privatized companies. Markets have so far been able to attract only primary trading activities, and secondary market trading is low. Regulatory enforcement needs to be constantly upgraded, but this weakness is not only due to the lack of enforcement capacity of the Commission but also due to the very low level of securities transactions in the markets, which will also provide the grounds for added expertise to the Commission.

The CROSEC faces major tasks of regulating the 2,336 registered joint stock companies under its jurisdiction. Croatia Securities and Exchange Commission (CROSEC) has formed a “Public Reference Room” which provides financial disclosures on 709 listed firms for the past three years, on a steady basis. This data is accessible by the investing public. These firms have adopted the IAS reporting systems, and are in full compliance of the IAS requirements, reporting for past two years on a quarterly basis. However, there are only six to ten companies regularly traded in the exchange.

There are a few concerns on the property ownership rights and their definition in the laws, especially under the company laws. It is understood that enforcement authority remains to be one of the most important areas for improvement for CROSEC.

Overall, both the operational and regulatory frameworks for a securities market is now in place, however the further development and deepening of the capital markets still remain an important

agenda. This will require comprehensive development of other legal and regulatory frameworks for the creation of the enabling environment and prudential regulation in all aspects of economic life in Croatia.

Pension Reform

There is a pending Pension reform for the mandatory second pillar of the social safety net. This may also be a possible source of capital markets and investment activity. However, the likelihood of a direct benefit for SME finance is small with this aspect of NBFi development, due to prudential investment requirements for pension assets. However, this remains to be seen.

3. Summary of Financial Sector Review for SMEs Development and Recommendations:

The banking sector is better developed than the other segments of the financial sector, however, it has been beset by many weaknesses, mainly due to several reasons: Vulnerability to macroeconomic developments; too many small banks; weakness of the enterprise sector; lack of adequate incentive structure; credit repayment culture; and the large fiscal cost of bank restructuring.

Case for the Development of Non Bank Financial Intermediaries (NBFIs):

Despite very high cost of lending rates to the borrowers, the Croatian banking sector have not been very profitable. Some of the banking sector problems can be corrected through a number of regulatory measures, but mainly by the achievement of a general improvement in the financial fundamentals of the underlying enterprise sector. The implications of a lack of bank funding resources available for the SMEs can be reduced by the creation of the appropriate incentives in the financial sector leading to the development of *non-bank financial intermediation* (NBFi). NBFIs may help reduce the over reliance on the weak banking sector for intermediation and provide an alternate source of financing the growth of SMEs. NBFIs may be especially important in channeling financial resources towards the special financial needs of SMEs by helping reduce the very high levels of cost of capital in Croatia to help foster the development of SMEs in a more business friendly environment.

4. Policy Recommendations:

While efforts continue to strengthen the banking sector, the demand for the development of different financial institutions has been growing in Croatia, as well as in the region. There has been an increasing importance for the NBFIs as an increasingly important segment of the financial systems in developing countries in the past few years. The growth of NBFIs will provide channels for investment to all segments of the economy, but more importantly to the SMEs, and risk spreading.

Even though there may be a degree of added fragility to the financial sector, this is often the result of a conscious effort to circumvent banking regulations, thus engendering market failure. In order to strengthen the financial sector, policies ought to be formulated and implemented

towards the development of NBFIs. This process could only be created under a coherent legal and regulatory environment, with effective policy frameworks and an enabling environment.

Following recommendations can be made to provide financial support the further development of SMEs in Croatia:

- Strengthen the banking and financial system, improving availability of funding for SMEs,
- Provide selected financial services through public policies where the private sector fails to meet the needs of SMEs,
- Put priority measures that will improve access to finance by SMEs and encourage the private sector for the provision of a broad range of financial instruments, such as;
 - Venture Capital Funds
 - Leasing Companies
 - Factoring Companies
 - Credit Unions
 - Credit guarantees for fixed asset and working capital funding,
- Seek to foster new, more favorable attitudes towards SMEs among banks and other credit institutions, linking this approach with the provision of new funding mechanisms,
- Ensure that good business practice and systems are followed when disbursing public funds and support for SMEs,
- Provide training and effective advice for entrepreneurs and staff in SMEs in dealing with the financial institutions and loan applications through sustainable business advisory groups,
- Ensure that access to finance is improved at the regional and local level, and the SME development policy addresses this issue.

It is recommended here that priority consideration is given to the creation of the following financial institutions and instruments in Croatia to help support the funding the SME development directly, backed by effective tax regimes:

- Venture capital funds,
- Leasing,
- Factoring,
- New Financial Instruments (warehouse receipts, legal tender promissory notes, corporate fixed income securities).

5. Opportunities for USAID Intervention:

USAID can provide technical assistance through its existing SEC/Treasury Dept. cooperative agreements in the delivery of advice for policy, legal and regulatory frameworks to the GOC, relative to the NBFIs.

USAID could also affect this process with high impact through a forum on NBFIs, which is currently pending for approval at AID/W for SOW. The forum will be delivered in partnership with the World Bank sometime in early May 2001 in an Eastern European venue.

B. Institutional Environment and Policy Frameworks for SME Development:

There have been various programmatic efforts in Croatia over the last several years to promote SMEs as an alternative venue to achieve employment and economic freedom, as the role of state in the economic life declines. However, Croatia still lacks an active and dynamic SME sector. Similar to other transition countries, there is the legacy of large state owned enterprises and a dysfunctional economic structure with a specific culture of business, import substitution and lack of understanding of internationally accepted standards of operational practice. This needs to change rapidly to build the economic base for its further integration into the global economy and especially to the EU.

There are now various institutions such as the Ministry of Crafts and SMEs, and financial institutions like HBOR to provide financing support for SMEs. Other government institutions include the Ministry of Economy, the Ministry of Tourism, Ministry of Agriculture and the Croatian Loan Guarantee Agency. (See Chapter V for a more complete summary of these and similar programs.)

The emergence of SMEs as an engine for economic growth has been negatively affected by numerous factors. Despite the existence of some institutions in support of SME development, many impediments to growth can be presented that are significant. Some of these impediments include:

- The lack of political will to complete privatization,
- Extremely weak and highly leveraged enterprise sector, impeding SME access to financing at a reasonable cost of capital,
- The lack of confidence of small businesses, entrepreneurs in the short to medium term prospects of the economy,
- Business environment which appears to be overly bureaucratic, and appears unfriendly especially to small businesses. Difficult business culture,
- Development of human capacity in professional management, quality staff (tourism sector),
- Obstacles to FDI flows which also affect the SMEs,
- Lack of effective enforcement of laws and regulations,
- Weakness in the judiciary capacity to prosecute, rampant corruption,
- Lack of clarity of property ownership rights,

- Difficulties of financing for plant, new machinery and equipment to increase productivity,
- High levels of taxation,
- High cost of capital,
- Lack of well defined SME development policy by the government.
- Inadequate or non-existent financial intermediation.

Recommendations:

Following recommendations are offered for consideration of a comprehensive policy initiative in order to foster the development of SMEs in Croatia:

1. Reducing Impediments to SME Development through Effective Institutional and Policy Environment:

Legal and Regulatory Frameworks

Significant changes in the legal and regulatory frameworks have been accomplished in Croatia over the last ten-year period. The legal framework supporting the market-oriented laws must consistently protect the property ownership rights and the fundamental aspects of implementation of contracts and obligations associated with business practices. Similarly, the system must have the proper institutions and agencies necessary to implement the policies and enforce laws. In this regard, the judiciary capacity must exist to complement the enforcement agencies by facilitating the resolution of disputes in a timely, equitable and just manner.

A recent USAID commercial law assessment, conducted in March 2000, indicates that the basic framework for commercial activity in Croatia is in place. Over the last ten years, a number of laws and regulations to build the legal infrastructure for the market economy have been adopted. These include:

- Company Law
- Bankruptcy Law
- Banking Law
- Securities Law
- Anti-Monopoly Law
- Real Estate Law
- Land Law
- Civil Law

The USAID study identifies a few difficulties and issues around the implementation and enforcement of the laws adopted from German or other European legal systems, which are mostly attributed to the lack of practical experience and interpretation and application of these laws. However, the specific laws adopted from Europe suffer from “hasty transplant syndrome” and needs to be addressed soon so that the country can be further integrated into the EU

harmoniously. Success in achieving this challenge will be determined by the GOC's willingness to place pragmatism above tradition, and the strong political will.

Implementing Institutions – The Judicial System: Courts, Agencies, Bankruptcy System

The institutions responsible for implementation and enforcement of key economic and commercial laws in Croatia suffer from severe resource constraints. There is room for judicial capacity building and skills training, especially in the application of economic and commercial laws. However, overall, the legal framework is in place, but the institutional framework has not been fully implemented.

For SME development, following agencies and institutions must be strengthened while simultaneously strengthening legal frameworks and enforcement to be more transparent, equitable and effective:

- Establish an anti-monopoly agency to protect the smaller business against unfair competitive practices,
- A centralized asset registry system,
- land cadastre systems
- implementation of contracts, and ownership rights, especially in cases of collateral for debt obligations with the financial sector relationships.

Supporting Institutions – Legal Education, Training, Professional Associations

Supporting institutions in Croatia are generally good to a considerable extent. However, there is the need to strengthen these institutions so that Croatian legal frameworks can be brought in harmony with the EU environment. Law schools and economic and business management as well as bankruptcy courts need skills upgrade to reach the level of understanding and sophistication required to be at level with their other counterparts in the EU.

SME Access to Bank Loans

The issue of lack of access to financing, taxation and the lack of well-defined government policies are the most important issues for SMEs development in Croatia. As explained in the previous section, banking sector problems has lead to the general distrust in the system. Even though conditions in the banking sector have been improving, confidence still lacks. Banks do not wish to lend to businesses, and SME's do not wish to borrow at high interest rates from the banks and provide the very high collateral requirements (in some cases 3 to 5 times the loan value). These are the main impediments to SME financing.

Taxation

Taxation is a very important issue in attracting new investments, both domestic and foreign. Currently Croatia applies a 35 percent tax rate on corporate income, with inter-company dividend exempted from any taxation. There is no tax on property however, there is a property transfer tax of 5 percent. The tax law allows for loss carry forward for 5 years. Asset depreciation rules are comparable to the other countries in the region, and allow for straight-line

depreciation up to 8 years on machinery and equipment, and up to 25 years on building. Recently there has been an amendment to the law to allow for double declining balance depreciation. The accelerated depreciation rules may help write off an asset on an accelerated basis, which would benefit the SMEs from the larger tax deductions allowing for larger access to internal equity capital.

Income taxes on personal income ranges between 20-30 percent, applied in conjunction with some coefficients. Recently, the Ministry of Finance sent a proposal to the Parliament to reduce the corporate tax rates from 35 percent to 25 percent, which is still pending.

The particularly relevant issue here, however, is the high level of employer contributions towards the already high labor cost in Croatia, which acts as a strong disincentive to expand small family business by hiring additional employees.

Impact of Tax policy: A Recent FIAS Study

According to a recent FIAS study, reducing tax rates will not be as conducive to attracting FDI to the country, as with the reduction of other administrative barriers to FDI flows and overall competitiveness of country. Even though Croatia's corporate tax rates are not any higher than the comparable countries in the region, further reductions in the corporate tax rates as a competitiveness measure will not benefit the country in a marginal sense. FIAS study sees no clear benefit to be gained from further tax incentives for investment but it will have much more to lose. Although popular, many tax incentives for investment have proven to be inefficient in attracting new investment, or only limited new investments, at best, while incurring relatively large costs in terms of foregone revenues.

Additionally, tax holidays do not work either. US- and Japan-based Multinationals typically seek to repatriate net profits to the home country. Though the host country tax holiday increases net profits, those same profits get taxed in the home country once they are repatriated. Hence, the benefit derived in the host country is lost when the profits are repatriated. The net effect, then, is that the host country taxpayers subsidize large multinationals. This also may lead to high risks in terms of economic distortions, domestic transfer pricing leading to the erosion of tax revenues, and corruption.

According to the FIAS study, it appears that taxes were not major deterrent to the FDI inflows. The alternative is to find the Croatian government cost effective tax solutions to attracting FDI, within the context of a sound corporate tax system. The FDI flows would have major implications on the SME by raising the demand for support services and subcontracting and outsourcing prospects, creating business opportunities.

The investors in Croatia complain more about over-regulation such as cumbersome registration requirements, difficulties in obtaining construction permits, over-zealous inspections etc. Another FIAS study under preparation analyzes administrative barriers to investment and recommendations for improvements.

Policy on SME Support Programs:

The SME sector has benefited over time from modest support programs, but they were largely ineffectual due to the lack of understanding the benefits of Entrepreneurship and SMEs on the part of the previous administration. The sector needs to be strengthened by very clear, and pro-SME policies, with adequate incentives backed by support programs such as business incubators, training to SMEs.

Croatia enjoys having a very large pool of highly skilled labor and science oriented human resources. This highly skilled human capital lacks the pool of management skills necessary to lead the private sector lead growth in a competitive global market economy. Major impediments to the development of management talent was the lack of support and technical assistance programs from the international donor community under the previous regime, which the other countries enjoyed over the last ten years of transition.

The lack of supply of quality pool of management talent which will lead the country into becoming more competitive producers of goods and services will be a long term task to develop, requiring the concerted efforts of the country's important institutions. Croatia needs to develop strategies to build a critical mass of skilled individuals, who are trained and educated in modern management techniques in international business schools, and networked with their counterparts on a global scale. For this reason, short and medium term issues exist to create the pool of well-trained Croatian executives and managers. The current situation of high levels of unemployment across the board, makes it difficult to manage and develop the enterprises to create the desired market economy base rapidly, especially in implementing the reforms in all sectors of the country. USAID may be able assist Croatia in this area.

2. Recommended Policy Actions Relative to Institutional, Legal and Regulatory Frameworks

In order to bring Croatia's enterprises to a competitive and sustainable level requires a number of policy actions to be taken. These are as follows:

- Legal and Regulatory Frameworks
 - ◆ Modernized systems for protecting property rights
 - ◆ Increased efficiency and integrity of the judiciary
 - ◆ Improved access to legal knowledge, information and policy process (transparency)
 - ◆ Solicit feedback from SMEs
 - ◆ Seek a change of attitudes by bureaucracy in dealing with SMEs
 - ◆ Distinguish between broad segments of the informal economy
 - ◆ Establish a comprehensive and continuing program to deal with all forms of corruption
- Institutionalization of SME Policies
 - ◆ State and publicly present the policies and implementation strategies of SME development,

- ◆ Specify priorities for SME sector and ensure that performance in achieving these is monitored in an open and transparent manner,
- ◆ Designate institutional, responsibility for SME policy at national, regional and local levels, and ensure clarity and coordination in the roles,
- ◆ Initiatives must be taken to improve the image of entrepreneurs across society,
- ◆ Assign proper legal responsibility to regional and local governments,
- ◆ Clearly explain the aims and reasons for central government interventions in SME policy,
- ◆ Establish regular dialogue with SME association representatives,
- ◆ Put in place actions and support programs to address the business development needs expressed by SMEs,
- ◆ Monitor the structure and performance of all aspects of SME sector,
- ◆ Provide training and guidance to public officials in dealing with SMEs.

Our conclusions and final recommendations for USAID intervention are presented in Chapter VI.

IV. CROATIAN COMPETITIVENESS INITIATIVE

A. Preliminary Competitiveness Assessment

Croatia is doing well in mobilizing foreign investment but ranks low in export competitiveness, policy environment and financial sector. While Croatia's benchmarking is being finalized, preliminary results show that Croatia is weak in export growth, policy environment and financial sector competitiveness as measured by multiple indicators. The relatively healthy recent performance in mobilizing foreign investment is related to recent privatizations.

Government of Croatia officials demonstrated that they place a priority on building Croatia's competitiveness. The Ministry of Economy in particular showed keen interest in receiving the Croatian Competitiveness Benchmarking exercise to be completed next month. They will also be attending the S.E. Europe Competitiveness workshop in Macedonia and I have agreed to ask Ireland's former Prime Minister to have a special side-session with the GOC delegation. There may also be some interest in producing an Annual Competitiveness Report along the lines of that produced in Ireland.

The GOC is over-relying on tax-incentives and favored access to EU markets as a competitiveness strategy. Over-reliance on tax incentives is creating tension between the MOF and the MOE and also raises issues between the GOC and the IMF. The recent FIAS report is indicative of this over-reliance. However, the temporary focus on free trade zones may provide a necessary jump-start for non-privatization related foreign investment and can help amortize the investment in business support infrastructure while giving a quick boost to employment. Croatia will also benefit shortly from favored access to EU markets. For example, Croatia will benefit from favored access to EU markets for a variety of products from sugar to apparel. These will provide short-term stimulus but they are not the basis for long-term competitiveness.

The private sector showed receptivity to the competitiveness approach. Business Intelligence 2000 which organizes one of Croatia's leading business leadership summits each year, asked that a presentation be made at its December conference at the Zagreb Sheraton. The Economics Institute has shown interest in co-sponsoring the publication and dissemination of the Croatia Competitiveness Benchmarking publication.

Voluntary business associations are weak but show promise. Apart from the non-voluntary Chamber of Commerce, the emerging business associations are still quite weak. The HUH is seen as being representative of member interests. The software association shows promise. The Bankers Association last year proposed an initiative to share information on arrears and defaults but has not followed up.

USAID has an opportunity to influence Croatia's leadership at a critical juncture. The GOC is taking decisions that will influence their future policy and strategy and may shape Croatian



The newly renovated Hotel W. A. Mozart in Rijeka exemplifies the recent revival of Croatia's once-prosperous tourism industry.

competitiveness for years to come. The GOC and the business leaders seem open to USAID input related to competitiveness, economic reform, E-commerce and areas related to stimulating investment, employment and exports. The commitment to creating a business-friendly environment seems genuine but there is limited capacity for implementation. Furthermore, private sector institutions such as *voluntary* business associations are still weak and in the emergent phases of their development. They have not yet developed institutionalized mechanisms of dialogue, although recent commitments to submit legislation for comment are encouraging.

Several industries stand out as having particularly strong competitive potential. Their prospects are summarized below:

1. Tourism:

Tourism competitiveness has suffered. Although the 2000 tourist season was the best since Croatia became a separate country, it is still well below pre-1990 levels. Furthermore, the value per tourist is relatively low, a perception that will be verified in the competitiveness benchmarking exercise next month. Croatia is now being positioned at the low end of the market. Some 80% of tourists come by bus or car. The industry is mainly providing low-wage jobs. Companies reported low profitability. High seasonality limits profitability for hotels and restaurants that must amortize fixed costs during peak months and then lay off a portion of the labor force. The HUH is an industry association that shows promise and could promote the Austrian model of tourism based on large numbers of family-owned businesses, bed and breakfasts and pensions. Better coordination between the MOT and voluntary industry associations such as the HUH could help propel the industry towards more effective counter-seasonal strategies. These could include health, golf, hunting,¹ mountain climbing, conference, nautical, nature and religious tourism.² The GOC could even consider medium term leases on several islands to celebrities to help the region recover some of its cache.

2. Information and communications:

The information and communication cluster offers potential for Croatia. The information and communication technology cluster includes important international companies such as Microsoft, Oracle, Siemens, Ericsson, Cisco, Compaq, IBM and SAP. The emergent software company association is beginning to coalesce and could be strengthened to deal with common problems such as brain drain, policy reform, investment promotion and SME linkages. Typical net starting salaries are DM1000 to DM 1,500 (DM 3,000 including social costs). Companies report that because of high taxes they need to provide in-kind incentives such as cars and other benefits. Microsoft reports the inability to offer stock options to employees “because it is still illegal for Croatians to foreign stock.” There are about 300 Microsoft certified people working in 64 certified Microsoft Solution providers. The competitiveness of this sector could be enhanced by improved education and training providers and by the development of research parks, knowledge

¹ There are 786 hunting districts in Croatia.

² Medugurje, a Roman Catholic pilgrimage site of the apparition of the Virgin Mary, is not in Croatia but is not far from Dubrovnik.

parks and service export zones building on the free trade zone strategy already launched. The nascent association could address key issues such as: building domestic demand, creating “export of service” linkages with US and Europe, E-Commerce readiness, workforce development and investment promotion to bring other US and European firms to Croatia.

3. Agribusiness:

Croatian agribusiness clusters face numerous obstacles. Croatia will have access to the EU market soon, which will offer short-term opportunities for building exports. Croatia can, for example, export sugar to the EU and collect economic rent thanks to high EU protection. Some meat exporters are targeting specialty beef to the demanding market of northern Italy. Numerous niche markets beckon. But obstacles include the slow pace of privatization of the *agrokombinati* and the lack of an effective agricultural credit system.

4. Banking:

The competitiveness of the Croatian banking cluster is likely to improve markedly with the internationalization of the banking sector. Foreign asset ownership is increasing this year from 54% to 71%. However, banks are still not lending to the SME sector. This could be improved if there were mandatory reporting on arrears and defaults, access to this database and support for the formation of credit bureaus. The one firm best positioned to provide this service, the Institute for Business Intelligence reports that it is reluctant to launch this service “because in Croatia it is supposedly illegal to collect data bases on individuals.” Transparency and universality of financial reporting could be the single most important tool for promoting democratization of credit and expansion of access to credit by SMEs.

The GOC could take steps to promote the national platform for competitiveness. The GOC has launched an aggressive policy to provide tax incentives and free trade zone regimes. A more sustainable policy might follow the Irish model that includes five basic components: access to EU markets, low but evenly applied tax rates, effective investment promotion of knowledge-intensive industries, investment in education and policy coordination through a National Competitiveness Council that constantly benchmarks Croatian performance. Other elements might include institutionalized dialogue with the private sector and a social compact with labor.

The biggest challenge is that of changing the mindset of the leadership. The challenge of transition requires a change in mindset. The problems are not so much technical in nature as they are of mindset. Making an impact on the mindset of leadership can take place through a number of means. In other countries, USAID has brought in the ex-Presidents of Ireland and Costa Rica, has published Competitiveness Benchmarks, has educated the financial and business press, has provided materials to the economic/business faculties, has launched media campaigns and has worked with industry clusters to influence strategy and build private-public dialogue.

B. Immediate Next Steps

The SE Europe Regional Competitiveness Initiative (which is already funded by the E&E Bureau's Market Transition Office) will focus on the following steps over the next 4-5 months:

- Publication of Competitiveness of Croatia: Benchmarks (looking for local co-sponsorship)
- Regional Competitiveness Conference (November 8-9th)
- Possible presentation at Business Intelligence 2000 Conference
- Modest in-country research on 3 industry clusters (looking for consultants)
- Identification of GOC counterpart for this exercise in Ministry of Economy
- Intensive presentations to Croatian leadership in first quarter of 2001.

C. Competitiveness Medium Term Initiative

The USAID Regional Bureau is sponsoring a regional competitiveness initiative, which will provide a Competitiveness Benchmarking exercise for Croatia, a regional conference, a limited survey of several industry clusters and some workshops in Croatia in the first quarter of 2001.

Assuming that private and public sector leaders are receptive, USAID/Zagreb can follow this up with a longer-term and more in-depth competitiveness project that would have a private sector component, a GOC component and a private-public dialogue component. The specific activities would include:

- Assisting the GOC in preparing a National Competitiveness Report focusing on removal of constraints to domestic investment, foreign investment, productivity growth, export development, SME expansion and employment generation.
- Provide quality international T.A. to help leaders of tourism, IT and agro-industry to upgrade strategies, improve standards, expand exports, generate sustainable employment and growth in productivity.
- Upgrade the emerging voluntary business associations so as to help them achieve sustainability, provide member services and play a constructive role in public-private dialogue.
- Assist economic and business faculties to incorporate competitiveness tools in their curriculum.
- Conduct media and public awareness campaigns on Croatian competitiveness.

V. CURRENT ENTERPRISE DEVELOPMENT PROGRAMS

A. Boosting the Entrepreneurial Culture

1. The Croatian workforce:

In general, the Croatian workforce is well educated and highly trained, but deficiencies in their education system reflect a lack of connectivity with current Western methods. Their higher business education programs are adequate but do not compare with those of Western universities. Also, no linkages exist between the business community and universities in Croatia. In the opinion of Zagrebacka Bank, young entrepreneurs find start-ups risky, preferring to work for large firms such as Siemens Company. The brighter, young entrepreneurs are seeking high rewards over short time periods in sectors like IT, and forsaking longer-term career development.



Collecting Sheep milk in Korenica

Brain drain, is a major concern for Croatia, which is at a critical time of their nation building. The “hollowing out” of the workforce can be attributed to higher salaries offered in Western Europe and the U.S.A. Women are present in many top jobs but their overall participation in the workforce appears to not be on an equal footing with men. Minorities (ethnic) also appear to have a difficult time in a somewhat ethnocentric culture. The unemployment in Croatia rate is now around 23%.

2. Wage and salary costs:

Croatian wages and salaries remain high by Southeast European standards due principally to the high cost of the country’s social programs (110% of wages). Only Poland pays more in net salaries (3.9%) than Croatia. Never the less, highly skilled Croatian IT workers are potentially competitive because they are less costly than their counterparts in Western Europe and the U.S.A. Among well-paid workers and entrepreneurs, conspicuous consumption is evident, and the propensity for “looking good” has replaced savings and investment. Price Waterhouse Coopers (PWC) reported that in the past six months, sales of automobiles were up 30%, matched by a decline of 30% in sales of food products.

Training and labor costs are important issues in SME development and the education of entrepreneurs in Western-style business methods is needed to balance local resources in terms of ideas and enthusiasm for business.

B. Industry Sectors Holding Most Potential for SMEs

1. Information Technology (IT):

SMEs are the likely growth area for IT start-ups because the technical knowledge is present in Croatia and SMEs have access to capital and joint ventures with foreign companies. There are 50,000 local firms (under 50 employees) in Croatia which provides an interesting market for the growth of IT firms. Microsoft invests in local companies and provide them with business skills (64 companies have received Microsoft certification). Microsoft also works with 1,000 retail outlets in Croatia, which sell Microsoft products. They are presently working with KPMG and the Ministry of Tourism to design systems, and could support USAID training and business education efforts.

Microsoft's Croatia office covers the Adriatic region. A staff of eleven full-time employees works primarily with computer dealers in Slovenia, Albania, Bosnia, Macedonia and Serbia. A total of 64 local businesses have been certified by Microsoft to be suppliers of their products. Microsoft uses Mercury International, a Swedish company, to provide local sales training, and there is considerable interest in the potential of a local MBA program. Microsoft would also be interested in arranging an "Round Table" with other major IT companies which have established a presence in Croatia.

ISKON, a local Internet Service Provider (ISP) was started in 1997 with support from the Soros Foundation. ISKON is now the second largest Croatian ISP with revenues of \$1.8 million and an expected growth rate of 200-300% within the next 2-3 years. The firm controls 20-25% of the business market, and 15-20% of the consumer market. Their big business clients number 30, compared to Croatia Telecom, which has 200-230 clients. ISKON sees a need for education in applied business management techniques, and anticipates there to be many opportunities for start-up SMEs in the IT sector. There are currently five ISP companies in Croatia and with high barriers to entry, industry consolidation is expected to take place. The Government's Telecom Ministry continues to hold its monopoly control over the ISP market.

2. Tourism:

Although the Croatian Ministry of Tourism is progressive, supportive of tourism entrepreneurs, and dynamic, the industry currently lacks key elements of a cohesive government master plan for tourism development. (For existing government tourism promotion efforts, see the profile on Ministry of Tourism in Section F.2. below.) A particularly valuable public sector contribution to tourism strategy, for example, would be for the Ministry to sponsor in consultation with industry, a physical plan for a few critical land use issues requiring special municipal zoning actions, such as reserving large land areas for golf courses. This type of limited planning exercise could significantly ease private investment in the kinds of infrastructure that could both extend a short tourism season (July-September), and attract more "up-scale" tourists.

Large companies are reluctant to invest in tourism, and since the war, it has been hard to get international investors to return to Croatia. Barriers to growth of SMEs in the tourism sector include a lack of coordinated industry direction, a slow moving privatization program, a lack of working capital for resorts, and a resistance to change to the traditional approach.

Small hotels and holiday camps, which represent 60% of the coastal accommodation, are closed seven months of the year. Most small businesses such as restaurants, cafes, shops and tourist agencies also close in the “off-season”. Many of the large hotels remain open year round in resorts such as Opatija, which is closest to Zagreb and caters to both foreign and affluent local tourists. A year-round tourism operation would stimulate SME growth and address unemployment in the coastal region, which ranges from 30 to 40%.

Adding new tourism activities to the traditional “hotel, beach, restaurant only approach” would provide important stimulation to SME development by making SMEs partners with larger resorts and hotels in their promotion of year-round business. PAKOSTANE, a successful 560-bungalow resort leased to Club Med, for example, offers a variety of activities for tourists, such as diving, hiking, cultural and wildlife park attractions. Adding value is important to any successful tourism strategy in both attracting new visitors and in maximizing tourist revenues.

According to a briefing the team received from the Ministry of Tourism, there are, in total, 2,890 enterprises and 14,389 "crafts" operating in Croatia's tourism industry. The total accommodation capacity is presently 670,000 beds or bed equivalents including hotels of various sizes, and campsites. Sailing and cruise ship tourism is an important element of the tourism industry, and there are presently 43 marinas with 14,400 moorings available along Croatia's spectacular Adriatic coast.

With the five years of war on Croatian soil (1991-1995), and the disruption from war in neighboring countries and regions for the balance of the 1990s, Croatia's tourism industry has yet to regain the volume it was averaging in the 1980s. The 2000 season was the first encouraging one in ten years, with annual overnight figures projected to exceed 40 million -- over half the 68 million average in the 1980s, according to Ministry of Tourism data.

Strategically, Croatian policymakers and tourism industry leaders now stand at a critical crossroads. They must decide what mix of tourism market niches they wish to appeal to. Currently the bulk of visitors are from neighboring Eastern European countries, and they represent a relatively "low-end" clientele. Improving recreational infrastructure (particularly golf courses and excursion operations), in addition to massive investment in renovation and new hotel and condominium lodging construction, will be key to any effort to attract a "higher-end" tourist. There are already encouraging signs, though, that the end of hostilities in the region is opening the way for private investor-funded renovation and new construction.

3. Services industries:

New opportunities in business services already exist or can be outsourced from larger businesses in a wide variety of sectors. These include the shipping and delivery of goods, services generated by the expanding free trade zones (FTZs), services needed to support for an improving business environment, an expanded hospitality industry season, new industries such as waste management, management training, and financial services.

4. Agribusiness and food production:

Although Croatia has 1.5 million hectares of arable land, (primarily located in the North and in pockets along the coast), approximately 1 million Croatians (over 25% of the population) live on 3 to 3.5 hectare sized farms. Comparable farm in Europe averages 30-40 hectares in size. Consolidation of farming land is expected to occur in Croatia, and this will eliminate many small farms and agribusinesses so new opportunities need to be found to replace the traditional approaches. A draft land consolidation law has been written but in the absence of a pension program, it is unclear that the older farmers would soon give up their small farms. The leasing of adjoining land in an “unofficial” consolidation in order to gain greater production capacity.

The majority State-owned “agrokombinati” continue to elude privatization. FLAG/Croatia suggested that the Agricultural Ministry had recently provided \$3 billion in operating funds to eight agrokombinati without a restructuring plan being put in place. Until internal decisions are made in the Ministry, the government will mark time on this issue. In the meantime, they would like U.S. assistance in addressing the future of agrokombinati. In the area of credit, banks are reluctant to finance agricultural production projects mainly due to issues of collateral. Inventory credit or warehouse receipts programs present ways to provide collateral and improve business liquidity. Overall, food distribution systems appear inefficient and expanding the role of cooperatives and group-owned businesses would increase domestic production and competitiveness.

C. NGO and Association Support:

Strengthening SME cooperatives and associations has been a successful development tool in the war-affected regions of Croatia. USAID’s program experience in this area could be used to compliment and balance the planned EU support to the private sector. Agribusiness cooperatives for example, could be an effective competitor for existing monopolies in food production and distribution. Generally speaking, NGOs such as associations and cooperatives are not adequately addressing the latest industry developments due to both a lack of funds and know-how.

1. Croatian Hoteliers Association:

Formed in 1992 in the Opatija region, the Association has 185 members representing 80% of Croatian hotel operators. The association is currently working with 500 hotels with an average bed capacity of 273. Their annual budget of around \$100,000 is raised by the association through the promotion of trade fairs, magazine publishing, an annual industry seminar, and contributions of \$50,000 from the 20% of larger members. The Hoteliers Association like most Croatians non-profit organizations are self-financing and receive no government or outside assistance.

Principal activities of the association include lobbying, arranging seminars, conventions and supporting the 15 specialized committees which address a range of new development ideas in areas such as marketing, promotion of new ways to add more value in services and receive more revenue from tourists coming to the region. The Association’s annual tourism conference in

Zagreb attracts about 240 industry representatives who each pay around \$65 to attend. The conference agenda includes a review of the past year, plans for the forthcoming year, and industry issues to be presented to the Ministry of Tourism.

Sound government policy and actions which can greatly assist the future development of the hotel industry include: (i) Repatriating the war refugees who occupy 35,000 hotel beds and are fed at hotel expense, and discontinue a program which has so far cost the hotel industry an estimated US\$15,000,000. (ii) Speeding up progress with hotel privatization. (iii) Reducing VAT to levels of 6-8% to increase competitiveness, based on similar programs in Greece and Spain. At present, tourists who pay in foreign countries are exempt from VAT. (iv) Supporting new ways to gain revenues from tourism such as extending the season, introducing new recreation facilities for scuba diving, golf, health spas, hiking and conferences. The industry is proceeding with plans for new conference facilities and expects an impact from the overall recreation program within five years.

2. The American Chamber of Commerce (AMCHAM):

The Chamber was formed in 1998, and now has a membership of 130 including a number of European companies. During the next 6-9 months the AMCHAM will be addressing policy reform issues including opposition to the new tax laws. They are also planning for a “Subcommittee for SME Development”, which will introduce presentations on how business is conducted in the West. Michael Glazer, Chairman of AMCHAM believes that SMEs in Croatia will make money and be the engine of growth for the economy. In response to suggestions that SMEs could beneficially cluster around larger businesses, Glazer noted that historically, big business and government agencies in Croatia had preyed upon SMEs, forcing them to exhaust their credit resources, and then replacing them with other SME suppliers. He doesn’t consider foreign ownership of banks will necessarily improve “banking response” to SMEs, and when asked about alternatives, he thought Credit Unions would work and could operate under the existing laws.

AMCHAM sees several priorities for the private sector, including: (i) Fixing the legal system and in particular, harmonizing with EU policies. (ii) Providing basic business education on the key issues of business start-ups. (iii) Providing credit and financing facilities. The Chamber has identified the impediments to foreign direct investment (FDI) of particular concern to AMCHAM are the conflicts with property ownership, and delays with the cadastre process. Foreign investors are not necessarily attracted to Croatia by “tax holidays”, they do however, require clear title to land ownership. Glazer’s opinion of Croatia’s Investment Promotion Law, was that it was really a “Tycoons’ Promotion Law”, also that the arbitration authority of the Chamber of the Economy, was too in league with government interests.

3. Small and Medium Enterprises Association (SMEA):

Currently, SMEA operates with 100 paying member (\$80 annual dues), and assists about 200 additional members who can’t afford association dues. SMEA membership includes one of the four Croatian internet providers, which as a group cater to only 6% of the private sector thereby providing expansion opportunities. SMEA contends that a significant hurdle to SMEs is the

\$2,500 capital that is needed to register a small company. In the absence of the USAID/FLAG program, which has supported SMEA, much of what the program is supporting, will cease.

4. Croatian Employer's Association (CEA):

CEA is a non-government, non-political, not-for-profit organizations with 5,000 members representing 400,000 employees and 14 associations such as the 100 member gas station employers association, and foreign firms with a base in Croatia. CEA has 18 branches and employs 10 staff in their Zagreb headquarters. They receive no assistance or funding from donors or government agencies. Members pay a small fee based on a quarterly assessment (this cost is one third of the mandatory fee small companies must pay to the Chamber of the Economy). Member companies of CEA are 60% medium-sized and 40% small, based on Chamber of Economy designations. An important function of CEA is training, and the association allocates one third of training resources to managers, and two-thirds to workers. They also participate in international programs such as a managers' training program in Germany sponsored by the German government. Individual participants in this program pay only their travel costs.

Priorities of the CEA include: (i) Fixing the lack of liquidity in the business economy. More than \$9 billion is owed between companies; (ii) Continuing the tripartite discussions between government, CEA and the Unions relative to business infrastructure; (iii) Lobbying the government on issues such as personal and corporate taxes, employee social cost taxes (110% of salary), bankruptcy laws, policy reform; and, (iv) Lack of financing available to members. Current interest rates of 8-15% are too high and members say that banks only want to lend to corporate and individual clients and not SMEs, because the perceived risk levels and the cost involved in daily support of SMEs.

5. Croatian Banking Association (Hrvatska Udruga Banaka):

Established one year ago, by the 18 largest qualified Croatian banks. Goals of the association include coordinating banking sector interests such as credit reporting, increasing professionalism by providing executive training, providing research and professional advice, networking, promotion of private sector development, building a national data center and acting as the liaison between association members and the Central Bank

The development challenge for all associations is to increase the effectiveness of existing industry groups by providing training, and implementing new ideas and the latest industry trends. Also encouraging the formation of associations for new industries such as information technology.

D. Non-Government Lending, Financial Support

1. Commercial Banks:

Since the economic crisis two years ago, banks have strengthened their capital base, although consolidation is expected to continue among weaker banks. Commercial Banks continue to

show a preference for individual and corporate lending rather than to SMEs. There is however, growing interest in SME lending because the banks are extremely liquid and are looking for new opportunities. Bank liquidity is mainly due to an increase in citizen confidence which can be attributed to: (i) An increase in foreign ownership of banks, expected to soon reach over 70%; (ii) Deposit insurance availability (up to \$12,500); and, (iii) Fresh capital inflows from Croatian expatriates living abroad, who see a more stable economy.

Since April 1999, the “unexpected” growth in deposits has amounted to \$300,000. Interest rates earned on deposits are: Kuna 9-10%; US\$5-6%; DM 4-5%, and according to the Zagrebacka Bank (60% foreign-owned), deposits are expected to grow at 20% for the next three years. In the case of Zagrebacka Bank, their 10-year experience in supporting SMEs has been a mixed success. As the private sector grows, the lack of working capital is becoming more critical and most of the loans offered are at high, short term interest rates.

Banks generally consider that the biggest impediments to approving SME loan applications are: (i) Lack of access to collateral and asset repossession; (ii) Unqualified consultants developing unrealistic business plans and strategies for clients; and, (iii) A high level of defaults on loans. The banks also perceive a shortage of good projects with reasonable bank risk, which contributes to their slow lending rate. Commercial banks such as Zagrebacka lend at 10% - 13%, short term interest, and up to 15% for long term (less for preferred clients) interest. Sole proprietors (crafts) and other micro enterprises pay as much as 20% in interest rates.

2. Foreign Ownership of Banks:

Foreign ownership of local banks is soon expected to reach 70%. Prominent examples such as Privredna and Zagrebacka banks, together with wholly owned foreign banks such as Raiffeisen, and Erste remain committed to SME lending. Privredna and Zagrebacka offer short-term loans to medium sized business engaged in the export and import sector. Zagrebacka’s loan rate for a medium sized business (up to 250 employees and \$140,000 in assets), would be 6% which includes a 2% Ministry subsidy for exporters. Privredna Bank plans to introduce a range of products for their “good clients”. This year, Zagrebacka Bank has received 40 applications for export loans (80% will be approved), and 200 applications for innovative projects (10% will be approved). All banks want to work with better-educated borrowers and qualified business consultants.

3. Credit Card Programs:

Use of credit cards in the domestic economy is widespread and repayment rates are reportedly high in an environment where default on debt is commonplace. Privredna Bank which represents American Express has 226,000 cardholders who presumably pay their accounts on time Zagrebacka Bank has 150,000 MasterCard accounts that also generally pay promptly. Credit card limits are around \$5,000 and are offered for personal use only.

4. Lessons Learned by Local Commercial Banks:

Commercial banks such as Privredna and Zagrebacka, have found that: (i) Loan requests for new enterprises are based upon an “idea”, and if they have a business plan, it is prepared solely to get the loan. (ii) Enterprises need business advice and guidance for the sound development of their ideas; (iii) Existing consulting firms use “cookie cutter” business planning software and don’t research their plans nor do they provide a thorough job for their clients. Charges for a business plan can range from \$1,000 to \$1,500, which could be better spent with reputable business consultants. (d) Clients are not well educated in financial matters and their ability to understand a project goes little beyond the “idea” stage. (e) Business clients often see their loan as an opportunity to buy their (leased) building, an expenditure, which distorts their cash flow of their business and does not contribute to productivity.

5. Subsidized Lending Programs:

The Ministry of Crafts and SME's sponsors a number of subsidized lending programs through the banks, including: (i) A loan guarantee program to support bank lending for loans of \$5,000 to \$50,000; (ii) A \$45 million program with Zagrebacka Bank to provide entrepreneurs and innovators with a 8% loans which are subsidized by guarantees to keep the rate low; (iii) A \$105 million export financing program through Zagrebacka Bank, at a subsidized interest rate of 6% and which has resulted in 60 projects to date. .

In 1998, the Privredna Bank pioneered a US\$10 million, subsidized municipal lending program for SMEs, in 15 of the country’s 21 municipalities including Zagreb. The bank contracted directly with sole proprietors and small businesses. Each of the 15 municipalities provided \$100,000 in capital which was matched 1:1 by the Ministry of Crafts, and 1:1 by the Ministry of Small and Medium Enterprises. The funds were made available with a two-year grace period for repayment. Privredna Bank matched funds on a 5:1 basis and at 8% interest rate which the municipalities further subsidized by 5% in order to provide 3% interest loans in the war-affected regions. Minimum loan size was \$5,000 with no maximum. Average loan size was between \$25,000 to \$35,000.

The subsidized lending program was promoted nationwide through media announcements. In each municipality, a five-person committee reviewed loan applications and decided “winners”, based solely upon the “investment idea” presented. Of the 450 applications received, 150 were rejected outright and 230 withdrawn. Of the remaining 70 applicants, 49 projects were selected for loans, and of these, only two are repaying. The 47 non-performing loans have been extended and could be successful with some further assistance. Privredna Bank’s program has since been redesigned in four of the original 20 municipalities where the program was introduced. The bank now requires the county to sign the contract with the borrower. Also, the loan committee now includes a bank staff member. Although unsuccessful, the same program is now being introduced by Zagrebacka Bank, also Reiffeisen and Este, two foreign-owned banks.

Issue for SME development: The majority of loan support programs for SMEs are subsidized by the government. The lending environment could be better assisted with continued support for

reforming laws and regulations that impede SME growth such as collateral law, credit reporting, and inventory credits.

E. Non-Bank Lending Alternatives for SMEs

1. Leasing programs:

There is considerable potential for SMEs to leverage scarce working capital through leasing. Leasing is possible under existing legislation, although there may be problems with implementation and enforcement. Major impediments for starting a leasing program include, a lack of support from the banks who see the usual problems of payment defaults and problems in repossessing assets. There are also accounting related issues such as depreciation and IAS compliance.

2. Credit Unions:

Credit unions exist under a special law and operate in most of Croatia's 21 counties, except Dalmatia. Credit unions are principally used as a repository for savings and for small household loans (approx. 12% interest rate). According to the Chamber of Crafts and Small Business, the repayment rate is high (99%). Credit Unions do not have sufficient capital for large scale lending to small entrepreneurs however, an infusion of capital for credit union lending or a partnership with a micro-loan program such as Opportunity International may broaden lending resources.

3. Micro Lending:

Opportunities abound for a systematic lending program to the approximately 90,000 registered craft businesses (sole proprietors) employing 1-3 people (114,000 total). The majority of these smaller businesses rely on self-financing, along with minimum support from subsidized municipal lending programs. For the most part, if a craft business can get a loan, interest rates range from 18-20%, rather than the 4-6% interest range that they believe are more manageable albeit unreasonable. NOA the local Opportunity International operation has reduced the loan default rate in their program to 5-6%.

4. Venture Capital (VC) and Investment Banking:

The VC field is dominated by foreign-owned firms, which are active in both the privatization and investment banking. For the most part, these firms target privatizing and restructuring, and investment in larger enterprises. They inevitably create a healthier and stronger business environment where SMEs can flourish.

Expandia, a joint Czech and U.S. partnership is primarily engaged in the privatization sector. They target tourism and basic manufacturing, and prefer "greenfield" enterprises to taking over an existing business (especially in hotels). Valuations made of formerly socially owned assets such as hotels often reflect what has been spent on the property rather than what profits can be made from the assets. Expandia would consider investing in SMEs if the right deal came along.

They see a need for business education and spend a considerable amount of their time on developing corporate governance issues, western-style financial statements and analyzing a maze of debts of potential investments.

Adriatic CP, is an investment banking and venture capital firm which started in 1997 and is 2% owned by Zagrebacka Bank. Adriatic CP targets investment in tourism and a variety of businesses such as jewelry stores.

The firm is interested in early stage businesses but not in start-ups. They see a lack of business education as a problem and would prefer to send neophytes to a professional business consulting service. Adriatic CP, usually don't invest in ventures below \$1 million in size and often send their smaller deals to SEAF. They also work with OPIC and INOVA, a private investment fund registered in Croatia.

SEAF - (Small Enterprise Assistance Fund): SEAF has been worked with USAID since March 1997, primarily in the war-affected regions but now country-wide. Equity investments to date are \$3 million, which represent 10 investments in Zagreb, and 5 in the Osijek and the war-affected regions. SEAF's program is limited to owning a maximum of 50% of the equity, with an investment cap of \$500,000. SEAF have been active in technology-related investments, and see the potential for increasing their involvement in this sector alone by \$5 million over the next 12 months. They support the idea of business training and the idea of introducing an MBA program. SEAF sees lack of liquidity as a major constraint to business growth.

SEAF has the potential to expand their equity investment program and to support a number of targeted sectors. As an example, SEAF is more than capable of launching an investment fund for the IT sector , which coincides with a stated a goal of the Ministry for Crafts and Small Business.

The VC companies recommend a number of areas for SME development. These include: (i) Service industries including services that large businesses can outsource such as shipping and delivery of goods; (ii) Family owned hotels which could be grouped, and marketed regionally; (iii) Information technology ventures which will become increasingly competitive as West European firms "look south" for expansion opportunities; (iv) High-value agricultural products such as organic fruits and vegetables; and, (v) A well structured food distribution system serving small establishments on the coast. They also see opportunities for SMEs in "firm level" business advisory services, tourist shops, local tour operators, and tourism management consultants. Low on the VC list of SME opportunities would be manufacturing.

Venture capital companies see impediments to SME investments as being partially structural and partially educational. Examples include: (i) Family-owned businesses which are run for the benefit of the family and reinvest little of their profits in the business; (ii) Complications with investment partnerships in family-owned business when a selling opportunity comes along and the family wants to keep their share of the equity; (ii) Shadow activities which involve partial cash payments and receipts which are not accurately recorded. An example is the jewelry business in Croatia, which is 90% "off the record", and which sells their products outside the country. Legitimate businesses soon become non-competitive.

Exit strategies represent another impediment for VC investments. With no liquidity in Croatia's capital markets, VC firms avoid using the local Stock Exchange. Their alternatives for "cashing out" their investment include the private market placements, international companies, or using foreign stock markets such as the Small Cap, NEUR MARKT in Frankfurt. Given the reluctance of banks to lend to SMEs, there is a role for alternative funding sources such as venture capital both in providing the capital, and also generating a deeper business structure which can be linked to further opportunities for SMEs.

F. Support for SMEs from Government Organizations

1. The Ministry of the Economy:

The Ministry of Economy leads the policy reform agenda relative to SME development. Their "open" and enlightened" approach to economic development draws upon a number of international development models. At present, the Ministry's focus is more with large and medium-sized businesses which are seen as the engine of growth, rather than the small and craft sized business. Foreign direct investment (FDI) is a national priority, and efforts in the first six months of 2000 have resulted in inflows of \$600 million which were mainly in equities but included \$17 million in "greenfield" investments. Initially, investments are flowing to larger companies, but as the Croatian market becomes more integrated with the EU, SMEs will achieve a greater share of foreign investment.

The expansion of Free Trade Zones (FTZs) is also a Ministry priority. At the present, eight operating FTZs, which employ 1,100 people, will be expanded to all 21 counties nationwide. Few craft businesses are participating in the FTZs which cater more to large companies which have the "required" foreign partners, strong business plans, required number of employees, and environmental and ISO standards which are required for EU accession. In the longer term the FTZ infrastructure which has been developed will attract businesses and provide advantages even after EU accession. The Ministry does not favor particular industries, however, sees potential in textiles, leather goods, auto parts, distribution services and ship building

FTZ concessions from the Ministry of the Economy include a range of programs such as: a ten-year tax "holiday" on profits and VAT; expedited customs; and, tariff relief on exported products made with imported/local raw materials. The Ministry also provides credits with commercial banks and employment tax incentives. Future activities planned by the Ministry include: (i) Establishing an Eximbank-like organization; (ii) Clustering Croatian businesses next to adjoining foreign markets; (iii) Expanding the State financed venture capital fund to \$17 million (an eleven-fold increase over last year); (iv) Establishing technology parks; and, (v) Establishing a national asset management fund.

In the area of development cooperation, the Ministry expressed a need for incubators to restructure companies in order to make them more competitive in all markets. They would also like to see an established local MBA program in which they would play a "connecting" role. The Ministry seems more disposed towards approaches from USAID rather than to the German development model (GTZ) which treats all countries of the region in similar fashion. The

Ministry believes that technical assistance provided to businesses should be based on real life experience and less on academic approaches

2. Ministry of Tourism:

The Ministry of Tourism has, since the appointment of the new Minister in the last year, taken sometimes controversial measures to strengthen the industry's competitiveness. Perhaps the most controversial -- and beneficial -- move has been to secure at least a limited degree of exemption from the Value Added Tax (VAT) for tour groups organized abroad that visit Croatia. This exemption is based on the premise that foreign tourist visits are actually a form of export from the country, and thus should be exempted from VAT. National debate now ensues concerning the possibility of extending the coverage of this limited tourism exemption to VAT.

Additional programs managed by the Tourism Ministry include two subsidy programs -- one for travel agencies and tour operators and the other for hotel companies. These subsidies, which were intended partially to compensate for the VAT they were paying, will be eliminated in 2001, as the VAT extension takes effect. In the longer term, the Ministry is working on the following key initiatives as well:

- Standards for classifying hotels, camps and other accommodations;
- A special program to set aside land for, and develop, golf courses -- a key element missing in the Croatian tourism product;
- Legislation to expand the selective VAT exemption for tourism enterprises.

The Ministry also oversees the work of the National Tourist Organization (NTO), which consists of a national board and head office, 21 county (and Zagreb City) Tourist Boards, and 289 resort, town, community and island Tourist Boards. The NTO members include hoteliers, travel agents, marina operators and other tourism company managers. They operate on public funds from the sojourn/tourist tax, membership fees, and supplementary funding from the State budget.

Various associations also operate in the tourism sector. In addition to various sub-groups in the government-run Chamber of Economy, tourism firms are represented by the following independent associations:

- Croatian Association of Hoteliers and Restaurateurs,
- Association of Croatian Travel Agencies,
- Union of Independent Travel Agents, and
- Croatian Camping Union.

Substantial tourism training capacity exists in Croatia, though it is of inconsistent quality. There are, for example, five university-level or specialized high school hotel and travel industry training programs, including:

- Faculty of Hotel Management in Opatija,
- American College of Management and Technology in Dubrovnik,
- Polytechnic of Dubrovnik (a high school specializing in tourism destination management),
- University of Zagreb's Graduate School of Economics and Business/Department of Tourism, and
- University of Split's Faculty of Tourism and Foreign Trade in Dubrovnik.

There are also 64 high schools offering vocational training for cooks, waiters, receptionists and other tourism support personnel.

3. The Croatian Loan Guarantee Agency:

The Ministry of the Economy provides support in the form of loan guarantees to banks such as Zagrebacka to encourage lending to start-up companies. Guarantees apply to minimum sized loans of \$5,000 and maximum of \$50,000. A large percentage of these loan guarantees (60%), are applied to businesses in the war-affected regions of the country.

4. Croatian Bank for Reconstruction & Development (HBOR):

HBOR, a state-owned institution, which is modeled on the German KFW aid program, follows the general economic development strategy planned by the Croatian government. From 1992-1995, HBOR has been involved in the physical reconstruction of the country. Since 1995, they have concentrated on a development role (with KFW), providing credit programs for (51%) privatized SMEs. So far, 50% of formally state-owned SMEs have been privatized and now need working capital because the available short-term loans are “killing” borrowers. Cronyism, however, remains as a major obstacle for SMEs getting loans, even with all the business plans and guarantees in place. HBOR emphasized the need for business education for entrepreneurs.

HBOR have signed three credit lines with KFW the German aid agency, to provide refinancing for SMEs. Basically this program addresses: (i) Existing, successful companies which need financial incentives; (ii) Geographic regions which have been targeted for stimulated economic development, such as the war-affected regions; and, (iii) Start-ups, “greenfield” entrepreneurs such as small family hotels in the tourism sector. Loans made to SMEs through banks are initially presented to HBOR, they then go to an intermediary bank. This bank then returns the application for HBOR for approval and HBOR signs an agreement with the intermediary bank at a 10-15% interest rate. Interest rates for “soft loans” to the war affected areas, range from 3-10%. HBOR takes 100% of the credit risk for all loans (soon to drop to 70%). All banks are

charged the same fees, and HBOR requires first call on loan collateral. Some banks additionally require access to borrower's assets even though HBOR is providing a 100% guarantee for the loan. Consideration is being given to reducing the ratio of collateral to loan requirement, which is presently on a 1:2 basis. Because real estate is not growing, it is not regarded as the ideal collateral, so progress on the cadastre is an important priority. If borrowers don't have sufficient collateral, the Croatian Loan Guarantee Agency can intervene, a process that takes three weeks for approval.

5. Croatian Privatization Fund:

The Fund is now engaged in the second stage of the privatization process. The focus is on the remaining large businesses and SMEs, which are offered for sale through by public auction. A summary of all assets (with pictures) will be listed on the Fund's web site, www.hfp.hr. Assets are being sold by the Fund in a transparent, case-by-case basis, starting with enterprises that are 25% owned by the State, then those enterprises which are owned 35-50% by the State, followed by enterprises which have a majority of State interest. In Croatia, bankruptcy offers a limited stage of protection that is less liberal than the U.S. Chapter 11 model. The Privatization Fund is working closely with Barents, a USAID contractor which began their Croatia operation in March 2000. Barents provides information, arranges seminars and valuation courses by request.

6. Customs Directorate:

The International Customs Cooperation program is currently involved with initiatives such as SEECI. The Customs Directorate operates with the same regulations for large and small companies. New laws, based on a November 2000 start dates are based on EU laws which were introduced in January 2000 and embrace WTO rules. Certain controls remain in effect to protect key industries. Customs does not provide any direct assistance to SMEs as services are available through the Chamber of the Economy and Chamber of Crafts. All information on tariff rates are published on the internet and in the Customs gazette. The use of freight forwarders are a requirement for all exporters and importers unless the individual business has a licensed employee to handle their business.

7. Ministry of Crafts, Small and Medium Enterprises:

The Ministry's main intervention with SMEs is made through the Chamber of the Economy and the Chamber of Crafts. Both Chambers classify companies by EU standards of (a) Micro - up to 10 employees; Small - up to 50 employees; Medium - up to 250 employees. A stated priority of the Ministry is to improve the availability of business education and information systems. To improve availability of SME financing, they have implemented a \$100 million lending program with municipalities and commercial banks. To date, the Ministry and Municipalities have approved 17 contracts through banks at an 8% interest rate. The Ministry has also provided \$5 million in subsidized credits for entrepreneurs and innovators, a program, which is operated by the Zagrebacka Bank at an interest rate of 8%. A program of export assistance provides \$105 million for subsidized 6% interest rates through Zagrebacka Bank. A new credit line will soon be offered through Zagrebacka Bank for lending to information technology (IT) companies. At

present, the modernization of industry is hampered by old technology, and the Ministry wants to see Croatian IT firms get a share of this expanding new market.

The Ministry also supports a program of Entrepreneur Centers. A joint program underway with eight counties which have the funds and the interest in participating in the program. The counties are required to provide a small amount of financial support together with office space, a staff of 1-2 experts, computer equipment, and training programs to support the Centers. Generally, the Ministry would welcome support for business support programs, however would prefer to use local rather than foreign consultants. They are also interested in venture capital program such as the Horizonte Slovene Enterprise Fund and Slovenian Capital Development Fund, which are joint EBRD and USAID activities. Micro credit programs too, are of interest to the Ministry, and they reported that an EU2.5 million program is presently being undertaken by the UNDP and EU. The Ministry does not have the resources at present to provide any government support for micro businesses. They would, however, be interested in discussing a loan guarantee program based on the U.S. Small Business Administration's 8(a) program

The challenge for the private sector will be to obtain more progress from the Government in the areas of industry restructuring, promised legislation, and privatization. At present, the majority of government support is either symbolic or involves systematic loan subsidization.

G. Non-Government Business Support Organizations

1. International Accounting Firms:

The major accounting firms such as Arthur Anderson, KPMG, Price Waterhouse Coopers (PWC), and Ernst are essentially engaged in providing their major clients with services such as tax accounting and auditing. Some firms provide legal services but almost no consulting services are offered. Anderson and PWC suggested that on average, the larger companies do not forward plan or have efficient accounting systems although their bookkeeping methods were sound. Businesses are required by law to adopt international accounting standards (IAS) and in the future, will adopt Croatian accounting standards. University academics, who presently maintain oversight for accounting training, don't have the right ("real world") experience to promote the adoption of sound accounting practices. The large firms operate their own in-houses training and staff recruiting programs. Anderson has a staff of 45, plus senior managers who are expatriates, mainly from Western Europe. PWC employs 103 staff in their Zagreb, Rijeka and Split offices.

PWC suggested that there were many impediments to the growth of SMES, such as the non-payment of business debts. Over 40,000 companies are now two to three years in arrears (40% owed by the Government). These arrearages have a disastrous effect on the cash flows of SMEs because the Government requires that VAT is paid within four weeks and assesses an 18% penalty for late payments. Another impediment involves slow implementation of laws due to a lack of trained judges. Other problem areas include: (i) Need for an improved workforce education, particularly with older employees; (ii) Mobilization of new (Western-style) business philosophies; (iii) Implementing sound corporate governance; (iv) Need for cost rationalization

because companies are out of touch with cost per unit for both labor and products made; and (v) The major banks are risk averse and not in the market for lending to SMEs and entrepreneurs.

The most promising SME business sectors recommended by accounting firms included: (i) Information technology, which has attracted a well-educated workforce, but is deficient in understanding private sector connectivity; (ii) Agribusiness generally, which can only improve with land privatization and more competition. Big food producers are doing well and enjoy monopoly situations. These firms include PODRAVKA, which is improving relationships with suppliers, AGRICOR in vegetable oils and mineral water, and LURA, a milk producer; (iii) Tourism, although very capital intensive, it offers a huge scope for improving both quality and cost, in order to compete with foreign resorts; and, (iv) Waste management services, an area of investment where an Arthur Anderson client had already expressed interest.

2. Croatian Consultants Network:

A nationwide network of private business consultants was established in 1997 under the auspices of the Chamber of the Economy. The Network, and CROMA a private consulting association, operate independently of the Chamber, and publish a directory of 250 consultants which include both specialists and generalists. Consultants are generally well educated but their value and usefulness to SMEs varies greatly. Chamber of the Economy members pay for the consultants' services, a cost which is partially subsidized by the Ministry of Crafts, Small and Medium Businesses. The Croatian Bank for Reconstruction and Development saw no problems for USAID providing similar advisory services using expatriate volunteers, and foresaw good opportunities for their integration with local consultants. Most SMEs are not aware of the services that the consultants provide, nor do they have the time to work with them. CROHTEC is a prominent local firm and affiliations between local and foreign firms do exist. Horwath and Horwath an American firm specializing in tourism is listed in the directory of consultants.

3. Chamber of the Economy:

The Chamber, which was formed in 1852, has had a tradition of helping and training businesses. They are now planning to expand their services to business start-ups and assist in developing links to local big businesses. Many consider that the Chamber is too closely aligned with the Government to be effective as a non-profit support organization. Membership of all registered businesses in Croatia is obligatory. The fee structure is similar to the Austrian model and is based on a fixed fee plus part of VAT. The role of the Chamber includes government lobbying, matching business partners, and management training. They have 20 country chambers, 12 departments such as small business, education, banking and agriculture, also 33 associations and affiliations. The Chamber believes that many small firms are not aware of their services, nor do they have the time to take advantage of what is offered in their program.

The membership structure of the Chamber is based on EU System. They have 60,000 members (including 600 large businesses), however 30% of these companies are either not viable concerns or are not operating. Due to prolonged bankruptcy procedures, many firms remain in business only to collect debt payments. Small businesses (up to 100 employees) and Medium businesses (up to 250 employees) are under the jurisdiction of the Commercial Court. Once a

Craft business (up to 50 employees achieves a profit of \$2,000, they must register with the Chamber of the Economy. To avoid moving up to the Chamber of the Economy, many craft businesses simply split their operation into multiple businesses. There are three “key” business laws applicable to the business community, i.e., Company Act, Handicrafts Act, and Cooperatives Act.

The Chamber sees a number of impediments to Growth of Small Businesses:

- (i) Lack of capital to start a business;
- (ii) Burdensome taxes and VAT;
- (iii) A backlog in the courts. Typically, a two to four year wait is due to the increased number of companies and a static court capacity;
- (iv) Basic laws created for small business are still in draft form and not yet published; and
- (v) A lack of education in business management and planning.

SME opportunities are seen by the Chamber in sectors such as manufacturing and production which use both old and new technologies, also in agriculture.

4. Chamber of Crafts (Sole Proprietors):

Established in 1994, the Chamber is a non-government, non-political organization belonging to approximately 90,000 registered members. The Chamber gets only symbolic assistance from the Ministry of Economy and comes under the jurisdiction of the Ministry’s Administrative Bureau.

Member businesses are engaged in the following sectors:

- (a) 20,000 small shops or crafts;
- (b) 17,000 restaurants, cafes;
- (c) 10,000 transportation;
- (d) 25,000 services;
- (e) 12,000 manufacturing, production; and,
- (f) 16,000 primary industries.

In prior years, the manufacturing, production group worked with large companies in a buoyant Yugoslav market but have since lost their technological advantage and skill levels because there has been no new investment in the last 10 years. Priorities for craft businesses are: (i) legal

reforms; (ii) tax payments and general treatment of craft businesses; (iii) education and training; and, (iv) Obtaining lower interest rates for loans, in the range of 4-6%. The Chamber of Crafts has 19 nationwide Savings-Credits financial units which provide financing to its members. These units are independent and enjoy very loan repayment rates. The potential for these types of financial institutions presenting opportunities for financing crafts ought to be further explored.

The goals of the Chamber are primarily to:

- Protect craft interests with the government;
- Promote crafts and related business through trade fairs and such; and,
- Encourage professional advancement.

They are connected with the Ministry of schools and training because the law requires that all registered crafts and small businesses obtain a diploma (license) to open a craft. There are 70 skill categories. The majority of craft businesses are self-employed or with one or two employees. Very few have as many as 50 employees.

Access to lending sources is limited for craft businesses. The Ministry does not have sufficient resources to truly support sole proprietors which are considered less an engine of economic growth than SMEs. The majority of businesses are self-financed and loans if they could be obtained, are needed in the range of \$25,000 to \$100,000. Some support is available and seven municipalities have been working with Zagrebacka Bank's line of credit, which is supported by the Ministry of Economy and the individual municipalities. In Istria County there are 800 support lines of which 60% are used by craft businesses at 9% interest. The City of Pula has a similar program, which provides subsidized loans at 7% interest rate. There are also bank lending programs, which link Croatian, and German craft businesses. It is interesting to note that German crafts pay a much lower interest rate (3.5%) to lenders compared to Croatian craft businesses (9%).

In general, craft businesses are skeptical of bank lending and consider the 18-20% loan interest rates offered to their sector to be too high. Crafts businesses have a great need for a micro loan program, which could be managed by an USAID program such as Opportunity International, or through the existing credit union network. A new bank for craft businesses has been proposed to the government but the response has not been encouraging. The Chamber is prepared to work with USAID in researching the legal issues involved in establishing a micro loan program for their members and will provide information for USAID/Zagreb.

Because the Croatian government provides mixed levels of support to associations, ranging from symbolic to subsidization of loans, the development challenge is to address these unevenly developed industry approaches, which are generally inadequate for business growth.

H. USG & International Donor Programs:

1. Ecolinks:

An established USAID program which can provide SMEs with grants up to \$10,000 for complete systems which addressing either urban or industrial environmental problems. The cost of waste collection is currently based upon the size of the house or business, and there are additional costs for the removal of packaging materials. In Croatia, municipalities, local government and associations also have access to the Ecolinks program - this could prove interesting for municipalities which have no funding for developing new waste management services. There exists a critical need to improve services, particularly in coastal regions, and the Ecolinks program recognizes SME opportunities in the installation of environmental equipment.

2. FLAG (Firm Level Assistance Group) program:

FLAG, an existing USAID program has worked for two years in a limited capacity as a business advisory service organization in the war-affected regions. FLAG sees opportunities for SMEs in a number of areas.

Firstly, introducing inventory credit and warehouse receipts activities in order to increase liquidity and orderly marketing of farm production. Small farmers currently need to sell their product at harvest time to (politically connected) trading companies so they are not able maximize prices. Because of this situation, producers are forced to borrow from the trading companies for next year's production and thereby become caught in a cycle of low expectations.

Secondly, competition in food processing and distribution, a generally inefficient and non-competitive, industry which relies heavily on imports — especially in the coastal region. The Agrokor Company controls much of this market and provides the hotels with both credit and product. Agrokor supplements local produce with imports and acts as an intermediary for most transactions. The majority of food consumed on the coast comes from Italy, Spain and Austria. Many of these foreign growers no longer ship directly to clients on the coast due to a record of past bad payment. FLAG believes that competition in food distribution should be a priority in SME development, and they have begun building a network of small farmer cooperatives, to provide competition for Agrokor. FLAG's group lending models have proved successful for one pork-producing cooperative that has begun shipping directly to customers in Split. Government subsidies for agribusiness currently go to large business like Agrokor, but cooperatives can also apply for a share of this assistance.

Thirdly, export of agricultural products is a potentially important growth area for SMEs. In the last six months, trade with Montenegro and Serbia has been higher than the past three years combined. Next year this volume is expected to double, especially as the transportation routes which have been closed, reopen. It was suggested that the dollar volume of Croatia's agribusiness exports to Montenegro and Serbia is higher than exports to Hungary. Croatia is filling an important role as a competitive leader in agribusiness among the Stability Pact countries, and this increased level of activity could attract foreign direct investment.

3. World Learning:

A popular USAID program which provides business and technical education together with in-country exposure and networking in the U.S. and Western Europe. Assisting business managers get first hand knowledge of current “western” techniques and business models has already proved a successful development approach and should be part of any SME strategy for Croatia.

4. Development Credit Authority (DCA):

DCA is a centrally managed USAID program, which provides risk guarantees to banks up to 50% for selected loans made to businesses. The DCA program has a ready application in the current, “risk averse” environments of bank lending, and can be applied to a variety of sectors. The Ministry of the Economy already sponsors a loan guarantee facility to support bank loans of \$5,000 to \$50,000. Two local banks are now engaged in this lending program - Zagrebacka and Privredna. Rather than compete, USAID could introduce a DCA facility to target key industry opportunities. Waste management could be one such industry sector. Currently operated by Croatia's 21 municipalities, waste management offers a number of SME opportunities where privatization is feasible and bank loans to entrepreneurs could be guaranteed by DCA.

5. Foreign Commercial Service:

The Foreign Commercial Service (FCS) maintains a small office in Zagreb including one FCS Foreign Service Officer and several assistants, to cover Croatia, Slovenia and Montenegro. They focus primarily on facilitating the work of U.S. exporters and investors interested in the Croatian market, but also produce and maintain an excellent network of contacts with Croatian government and business leaders. The FCS office in Zagreb maintains a close and productive collaboration with USAID/Zagreb.

6. Overseas Private Investment Corporation (OPIC):

OPIC will soon be distributing their \$150 million development program for the Stability Pact countries. This program will offer a number of opportunities for NGOs such as the Small Enterprise Assistance Fund (SEAF), and qualified Croatian businesses.

7. U.S. Trade & Development Agency (TDA):

TDA might support a feasibility study for KARIKOVOCE, a fruit juice production company.

8. EBRD - European Bank for Reconstruction & Development:

EBRD's mandate involves a wide variety of interests, including: providing support for public/private investments; balance sheet reconstructing; business plan preparation and assistance with FDI and VC investments; infrastructure financing; and, equity participation in banks and businesses. EBRD'S investment in Croatia to date has been E575 million and is increasing to E670 million. They maintain a good funding pipeline mostly from the West European private sector. Their SME program provides financing through twelve, on-lending

bank facilities. Presently, EBRD are working with 180 small companies, and their average loan size is \$80,000.

EBRD has observed that a lack of foreign investment in Croatia is linked to a lack of transparency by local companies, inadequate business training, and available information. SME business advisory services are important, and EBRD have a Netherlands program linking businesses with qualified consultants and incubators.

Micro finance is an overlooked sector in Croatia and USAID and EBRD may partner in a new program with the U.S. providing technical assistance and the EBRD, on-lending facilities. Commercial banks won't lend to microenterprises without a grant compliment of some sort, or other "incentive".

EBRD suggests that many industries are in complete disarray including Agrokombinats and older, state-owned manufacturing companies. There are 1900 companies in the privatization universe, 300-400 of which are saleable - the rest will collapse. The assets of these State-owned companies will need to be separated and independently restructured. The ship building sector, which continues to be subsidized by the government, is not addressing issues of restructuring, asset divestiture asset or downsizing. Because the shipping industry is traditional, and a large employer, the government is reluctant to act. EBRD won't intervene until the industry's infrastructure is fixed.

9. European Union:

The initial phase of the EU strategy for SME lending will include a budget of approximately \$3 million. The program will be executed through UNDP. EU plans to eventually address three major aspects of SME development in Croatia: (i) Harmonization of institutions and regulations relative top EU criteria; (ii) Selected regional priorities; and, (iii) Improving conditions for Craft and SME businesses. Among representative measures are:

Special EU financing programs for SMEs: (i) Program "Gazelle" for dynamic entrepreneurs; (ii) Program "Snow-Ball", financed by raised local funds in co-operation with banks that should amount to US\$80,000.000 during this year (signed contracts with 8 regions and 4 banks - Zagrebačka Banka, Varaždinska Banka, Podravska Banka, Raiffeisen Bank of Austria) with low interest rate - expecting new employment and production for export. (iii) Financing export oriented programs that introduce new technologies with a plan to ensure US\$13,000,000; (iv) Program "Commercialisation of Innovations" with the budget of US\$4,000,000; and, (v) Restructuring program promoting development projects aiming to accommodate to the market with the budget of US\$5,500.000.

International co-operation: There have been various efforts oriented towards the encouragement of investment and transfer of technology for the rapid creation of employment with SMEs in Croatia:

- (i) Private Sector Development Project has been going on in close co-operation with the World Bank aiming to strengthen the development of “Centres for preneurship”;
- (ii) Pilot Project "Learning and Innovation Loan" (LIL); 13 projects of Centres for Entrepreneurship have been realised and ready for investment;
- (iii) "A Memorandum of Understanding” was implemented in co-operation with the government of Netherlands as the part of the project “Support for the development of SME in Croatia" (three counties are active in the scope of this project);
- (iv) “A Train of the trainers” program has been conducted; 20 trainers and 30 counsellors have been trained under the program of prescribed courses and workshops. A new project as the continuation has been agreed upon with the budget about (US\$400,000); and
- (v) Program for Support of SME Development in co-operation with GTZ (Gesselschaft für Technische Zusammenarbeit, gmbH) Germany, providing technical assistance in 8 counties, partially completed in 2000, but the new project with the budget US\$1,100.000 is to be realised during the period 2000-2002.

Training programs needed for ongoing for SME development: (i) Education of trainers and counsellors for SME development. 55 trainers with certificates are currently in action and by the end of year 2000. 20 new trainers and 190 counsellors with related certificates should be ready to actively enter the field of SME training; (ii) Licensing the members of Croatian Consulting Network – (currently 21 licensed); (iii) Regular Education Program for Entrepreneurship Development; (iii) Program of education for 20 specialised crafts - 5000 students are currently in craft-schools.

Entrepreneurship promotion programs and material include: WebPages, Bulletins, TV-series, and SME entrepreneurial and investment publications.

Policy Priorities for SME in Accordance with EU standards: (i) Harmonising laws with EU standards; (ii) Building prosperous business environment; (iii) Enhancing the competitiveness; (iv) Promoting innovation, capacity and efficiency; (v) Improving international networking skills; (vi) Promoting availability of information and knowledge.

VI. CONCLUSIONS AND RECOMMENDATIONS

A. Key Opportunities and Strategic Gaps:

USAID/Croatia has resolved to expand its economic growth program substantially and to extend it well beyond the war-affected regions to which, to date, it has mostly confined its activity in this area. The team strongly supports this decision, and sees a definite niche among donors that USAID should exploit.



View of Dubrovnik and its harbor

With European Union accession steps now well under way in Croatia, the EU will undoubtedly remain Croatia's most influential donor. The EBRD will also play a strong role in shaping donor assistance to the private sector. The EU and EBRD programs, combined with other GOC initiatives (such as the SME lending programs supported by the HBOR, Ministry of Crafts and Ministry of Agriculture), all emphasize various forms of subsidized credit and lending for SMEs. Mostly, those initiatives operate through the banks.

Assistance in the broad, macroeconomic and sector, policy areas is also dominated by the EU, the IMF and the World Bank. This area will primarily be shaped by the overwhelming economic priority for Croatian policymakers: joining the EU as rapidly as possible. Hence, relatively little opportunity exists for the United States to engage broadly in this area, though more focused targets of opportunity may arise.

Fundamentally, the most promising strategy for USAID would be a three-pronged assault on the fundamental microeconomic constraints to enterprise formation and expansion. The key constraints that need to be addressed are:

- Lack of skills and knowledge of basic business and Entrepreneurship strategies and practices among SME managers and entrepreneurs;
- Lacunae in the basic availability of financial performance and loan repayment data banks need to minimize the risk and cost of SME lending; and
- Unlocking the massive concentration of economic assets still frozen in the glacial grip of public sector enterprises that have in the last 12 months just begun to receive the government's serious attention.

B. Recommendations:

USAID/Croatia's private sector strategy should focus on generating employment and investment. The centerpiece of the strategy should be positioning key Croatian industries as leaders in enhancing Croatia's international competitiveness. This central thrust will also require

assistance in two supporting, but vital, areas: enhancing financial services and accelerating privatization.

This tripartite strategy is summarized in the recommendations below.

1. Competitiveness Strategy

The team recommends two distinct – but interdependent – thrusts to improve Croatia’s competitiveness. They comprise the centerpiece of the proposed strategy. First, Croatia’s overall competitiveness approach has to emerge from a public-private dialogue at the highest levels, which USAID would stimulate and then build upon with a selective pattern of technical advisory services. Second, USAID/Croatia could help to strengthen and expand the small/medium business and microenterprise communities and the fabric of associations that supports and represents them.

a. Strategic competitiveness initiative:

Preliminary interviews and research indicate that tourism, information technology, textiles, and possibly certain elements of food industries are examples of potentially competitive industry clusters for Croatia. By working with some of these industry groups, in the context of high-level dialogue with government, financial services industry and education leaders, USAID/Croatia could help assure that these industry groups contribute to the fullest extent the lasting employment and earnings opportunities of which they seem capable.

Recommendation: That USAID/Croatia adopt a competitiveness initiative that will include the following key elements and steps:

- Present to 8-10 industry clusters and work with three on the basis of their response to develop strategies and action initiatives including market linkages, information access, technical assistance, workforce development and advocacy.
- Assist Government of Croatia (GOC) Ministry of the Economy and other public and private organizations to publish a Croatian Annual Competitiveness Report along models of similar report published annually by Ireland, but including inputs from private sector clusters.
- Benchmark Croatia’s macro- and microeconomic policies, institutions and environment relative to other EU accession countries and the EU itself.
- Provide quality international technical assistance to help leaders of tourism, information technology, textiles, selected food industries, or other promising sectors, to improve standards, expand exports, generate sustainable employment and growth in productivity.

b. Business and Entrepreneurship program:

The pervasive climate of non-payment of business debt, the relative abundance of bank lending liquidity, and the numerous ongoing and planned subsidized credit schemes, argue in favor of USAID avoiding the customary or “mainstream” approaches of direct SME lending or business advisory service delivery. Instead, the team believes that the key to imparting improved Entrepreneurship, marketing, business planning and management accounting skills, would be to challenge the local business advisory/consulting community to develop these basic skills among its clientele, the SME community.

Recommendation: USAID/Croatia could issue a Request for Proposals (RFP) inviting consortia – perhaps led by local consulting firms – to assemble a diverse but manageable group of Croatian and US partners. The RFP scope of work would specify that the successful group must be capable of developing both a basic business training curriculum, and a business/marketing plan for serving as a “wholesaler” of this training. The “retail clients” who would actually offer the training to entrepreneurs would consist of various industry-specific business associations, groups or other institutions who would seek tailored packages of training appropriate to their particular members, constituents, students or clients.

2. Enhanced Financial Services:

Given the prevalence and variety of subsidized credit programs already operating, and their near-universally disappointing performance, the team determined that USAID’s resources could be more productively devoted to addressing the following array of root causes of limited SME access to appropriate credit. The team thus recommends that USAID/Zagreb consider adopting the following recommendations:

a. Encourage SME lending by enabling credit reporting firms to emerge:

Limited, short-term technical assistance could contribute valuable policy analysis to the Central Bank, thus launching the process. This policy analysis would need to persuade the Central Bank to require that all banks report non-payment of debts, no matter how small, to a central database. Credit reference firms could then emerge for the purpose of combining those data with credit information from other sources and offer to banks and individuals a service not presently available here: reliable data on a borrower’s credit history.

b. Introduce a variety of non-bank financial institutions and practices:

The following specific business practices and financing approaches are the four best means the team identified of diversifying the range of financial products available to SMEs. They are for USAID to employ, where possible, existing teams, and where none exist, to issue a request for applications (RFA) for an appropriate NGO to:

- Create **industry-specific venture capital**;
- Help underwrite the analysis and if necessary, financial guarantees, to help commercial banks and other creditors to establish the practice of honoring grain and agricultural product **warehouse receipts**;
- Similarly, encourage **leasing and factoring** (obtaining credit from a bank, or payment from a buyer, for the discounted value of one's accounts receivable) services;
- Consider the potential to engage USAID's various **loan guarantee** services in favor of banks willing to expand SME lending. As an example, the Development Credit Authority (DCA), could target specific industries such as waste management. The privatization of these municipal functions could be assisted with a combination of loan guarantees through local commercial banks, and technical assistance presently available through the USAID "Balkan Infrastructure Initiative," and
- Explore **micro-finance assistance**, which could be furnished by any of several highly specialized and successful NGOs through an RFA selection process.

3. SME-Related Privatization:

The Government of Croatia, for the last seven months, has been demonstrating relatively strong signs of political will to address relatively difficult aspects of privatization. The first set of major privatization actions since the early 1990s is now being readied. However, two opportunities exist for USAID to help accelerate this relatively slow process:

a. Deconstructing the Agrokombinats:

Today over 40 large, diversified, socially owned agricultural and food companies (agrokombinats) continue to exist, and after a decade of privatization, most are still majority-state-owned. The GOC Privatization Fund Director has asked the team whether USAID could help them to select and engage the agribusiness and corporate restructuring expertise that would effectively identify profitable spin-off enterprises and assist in preparing them for divestment.

Recommendation: That USAID/Croatia select competitively a consortium, firm or NGO qualified to restructure, divest, and help private entrepreneurs launch, successful food processing, production and trading firms derived from the assets of the more promising agrokombinats. The team, working closely with USAID/Croatia's existing Barents advisory team, would also assist the Privatization Fund in liquidating those ill-suited to restructuring or breakup.

b. Privatizing selected municipal waste and water/wastewater services:

Using existing USAID-funded technical assistance teams from the Ecolinks and Local Government projects, explore with USAID-assisted municipal governments the possibility of reducing public outlays and improving public service by privatizing (contracting out), sanitation and water services presently being provided by public entities. These two programs have succeeded in collaborating of their own accord in one instance already. They could probably do so again to great mutual advantage, particularly in Rijeka (coastal tourism/shipbuilding city) and Varazdin (in a war-affected region).

ATTACHMENT 1

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ATTACHMENT 2

List of People Visited and Interviewed

Last Updated October 24 @1542

October 16 – October 27, 2000

Schedule for SME Assessment Team:

Chris Brown, John Godden, Demir Yener, Kevin Murphy

Monday, October 16, 2000

- 830 Damir Novinic, Keith Sherper
Venue: USAID office
Trg bana Jelacica 3/3rd floor
Tel: 4811-977, Fax: 4816-143
- 930 Noel Page, ARTHUR ANDERSEN
Venue: Vlaska 78
Tel: 4611-456, Fax: 4611-465
- 1100 Andrew Krapotkin, EBRD
Venue: Petrinjska 59/5th floor
Tel: 4812-400, Fax: 4819-468
- 1200 Ministry of Economy
Kamilo Vrana, Assistant Minister
Venue: Ulica grada Vukovara 78
Tel: 6106-112, Fax: 6109-112
- 1500 Entry briefing
Pamela Baldwin, Michael Greene, Damir Novinic
Venue: AID office
Trg bana Jelacica 3/3
Tel: 4811-977, Fax: 4816-143
- 1600 Jill Byrnes, Marija Sabol, USEmbassy/ECON
Patrick Hughes, FSC
Venue: Andrije Hebranga 11

Tuesday, October 17, 2000

- 900 Croatian Chamber of Commerce
Ivana Zmegac, Lidija Svaljek
Roosveltov trg 2
Tel: 4561-555, Fax: 4828-365
- 1030 Michael Glazer, Auctor Consul. Company
(President of Am. Cham. In Croatia)
Venue: Palmoticeva 2
Tel: 4814-139, Fax: 4814-143
- 1200 Ivica Smiljan, Ante Roncevic, Security Commission
Venue: Bogoviceva 1a/3rd floor
Tel: 4811-406, Fax: 4811-507
- 1330 Katarina Bakija, Tonka Jolic, (Davor Cilic) Custom
Venue: Humbultova 4a
Tel: 6102-333, Fax: 6155-280
- 1500 Tanja Rukavina, PricewaterhouseCoopers d.o.o.

Heinzlova 4a
Tel: 4600-800, Fax: 4553-449

Wednesday, October 18, 2000

- 0900 Ana Ivancic, Mira Dronjic
Croatian Bank for Reconstruction and Development
Venue: Gajeva 30 a
Tel: 4591-706, Fax: 4591-708
- 1030 Zeljko Kardum, Public & Government Relations
The Zagreb Stock Exchange
Venue: Ksaver 200
Tel: 4677-684, Fax: 4677-680
- 1300 IskonInternet
Damir Sabol, Managing Director
Venue: Savska 41/10th floor
Tel: 6000-709, Fax: 6000-777
- 1500 Mark Alley, Expandia
Venue: Bukovacka cesta 175
Tel: 2446-222 ext.114, Fax: 2445181
- 1630 Sandra Balent, EcoLinks (Tel: 4873-622, Cell: 098-388-649)
Venue: AID office

Thursday, October 19, 2000

- 900 Davor Majetic, Microsoft Hrvatska d.o.o.
Association of Software Developers
Venue: Trg Drazena Petrovica 3/2nd floor
Tel: 4802-506, Fax: 4843-688
- 1030 Eufrona Snyder, Booz Allen & Hamilton
Venue: Svacicev trg 12
Tel: 4856-575, Fax: 4854-595
- 1200 Mario Bebek, CP Adriatic (Investment Fund)
Venue: Trg bana Jelacica 3/6th floor
Tel: 4819-858
- 1500 Milivoj Jurisic, Croatian Chamber of Commerce
Head of the SME department
Venue: Draskoviceva 45, 5th floor
Tel: 4606-777, 4606-709, Fax: 4606-761

Friday, October 20, 2000

- 830 Privredna Bank Zagreb
Gordan Miler, Zvonko Agicic
Venue: Ilica 5 /1st floor (Oktogon)
Tel: 4723-816, Fax: 4723-966
- 1000 Croatian Privatization Fund
Hrvoje Vojkovic, President
Venue: Ivana Lucica 6-8
Tel: 4569-119, Fax: 4569-140
- 1100 James Hambric, BARENTS
Venue: Ivana Lucica 6-8
Tel: 4569-119, Fax: 4569-140

Small/Medium Enterprise Support and Competitiveness Concept Paper

- 1300 Vlado Galicic, Croatian Hotelier Association
Venue: AID office
Tel: 051/711-415, Fax: 051/711-567
Faculty Tel: 051/292-633
- 1430 Depart Zagreb for Rijeka
Budget Rent a Car
Kneza Borne 2 (Sheraton Hotel)
Tel: 4554-936, 4554-943
- 1700 Arrive Rijeka
Hotel Bonavia
Dolac 4, 51000 Rijeka
Tel: 051/357-100, Fax: 051/330-243
- 1800 Robert Host, Hotel Director/Hotel Bonavia d.o.o.
Venue: Dolac 4
Tel: 051/333-744, Fax: 051/335-969

Saturday, October 21, 2000

- 1000 Nikola Bacic, Director/ Hotel W.A. Mozart
Venue: Obala Marsala Tita 194, Opatija
Tel: 051/271-877, Fax: 051/271-739, Cell phone: 099/486-216
- 1200 Hotel Ika, Primorska 16, Ika
Josip Brkic, Owner
Tel: 051/291-777, Fax: 051/292-044
- Antun Katunar, Winegrower
Island of Krk
Tel: 051/857-393

Monday, October 23, 2000

- 0930 Vlatka Pavlinic, Mirjam Bach, Zagrebacka Bank
Venue: Trg bana Jelacica 10/3rd floor, room #5
Tel: 4808-380, 4808-383, Fax: 4813-812
- 1000 Ministry of Agriculture and Forestry
Lidija Mrkoci
Venue: Ulica grada Vukovara 78
Tel: 6106-685, 6106-635, Fax: 6109-203
- 1100 Ivan Teodorovic, Economic Institute
Venue: Trg J.F. Kennedy 7/1st floor
Tel: 2310-990, Fax: 2335-165
- 1300 Katarina Jagic, SMEA
Tel: 2910-594, 2441-422, Fax: 2441-422
Venue: AID office
- 1500 Josip Kardun, Olgica Spevec, Maja Brinar/Ministry of Economy
Venue: Ulica grada Vukovara 78
Tel: 6106-924, Fax: 6109-114

Tuesday, October 24, 2000

- 0815 InterAgra
Mladen Mavricek
Venue: Trg bana Jelacica 7/3

Small/Medium Enterprise Support and Competitiveness Concept Paper

- Tel: 4814-222, Fax: 4816-936
- 900 Croatian Chamber of Kraft's
Petar Sindicic, Secy and Arduino Volja
Venue: Ilica 49/2nd floor
Tel: 4806-666, Fax: 4806-676
- 1000 Zavod za poslovna istrazivanja/Institute for Business Intelligence
Sinisa Grgic, President/CEO
Venue: Varsavska 1
Tel: 4818-111, Fax: 4818-399, Cell: 091/11-000-11
- 1000 Agrokor, Dubravko Kmetovic
Venue: Trg Drazena Petrovica 3
Tel: 4894-111, Fax: 4894-081
- 1000 Ministry of Finance - Velimir Rajkovic
Venue: Katanciceva 5
Tel: 4591-333, Fax: 4591-393
- 1300 Zeljko Ivancevic, Croatian Employer's Association
Venue: Praska 5/3rd floor
Tel: 4920-223, Fax: 4920-208
- 1300 Dr. Zoran Bovacek, Croatian Association of Banks
**Venue: Nova Ves 17/1st floor (Shopping center Kaptol),
Tel: 4860-080, Fax: 4860-081**
- 1500 Faye Rishog, Ministry of European Integration
Venue: Ulica grada Vukovara 62
Tel: 4569-336 Fax: 4569-328

Wednesday, October 25, 2000

- 0800 Depart I-Conti for Petrinja
- 0900 Gavrilovic d.o.o.
Milica Opacic, Director
Venue: Gavrilovicev trg 1, 44250 Petrinja
Tel: 044/811-266, 811-041, Fax: 044-814-041
- 1500 Ministry of Crafts, Small and Medium Entrepreneurship
Miljenko Leppee, Sanja Zelinski-Matunec, Marina Lang-Perica
Venue: Ulica grada Vukovara 78
Tel: 6106-111, Fax: 6109-223
- 1500 Keith Sherper, AID Washington, Damir Novinic
Venue: AID office
- 1700 Kevin Murphy
Debriefing with Pamela Baldwin

Thursday, October 26, 2000

- 0930 Jonathan Cooper, SEAF (Investment Fund)
Venue: Praska 10/2nd floor
Tel: 4811-913, Fax: 4811-220
- 1100 Brad Davis, Zlatko Janecic, FLAG (Venue: AID office)
Cell: 098/252-896
- 1300-1700 Working on draft report

Friday, October 27, 2000

Debriefing

Pamela Baldwin, Michael Greene, Damir Novinic, AID
Patrick Hughes, Jill Byrnes, Marija Sabol, USEmbassy
Venue: AID office, Trg bana Jelacica 3/3
Tel: 4811-977, Fax: 4816-143

Ministry of Tourism
Venue: Ulica grada Vukovara 78
Tel: 6106-306, 6106-111, Fax: 6109-300

TBC

ATTACHMENT 3

SOW FOR CROATIA SME ASSESSMENT AND STRATEGY DEVELOPMENT

I. Introduction:

In early October USAID/Zagreb will begin the process of developing a country strategy that will guide the Mission's program over the next 5 years. As part of that process, the Mission has requested the assistance of an AID/W team to do an SME assessment in late October. The goal of the assessment is the production of an SME strategy that can be incorporated into the overall five-year country strategy. This document will also serve as a concept paper from which a detailed SOW for procurement(s) for SME program implementation can be developed at a later date. The assessment will identify constraints to increased private sector investment in SMEs, identify key growth areas and provide specific recommendations to the Mission on exploiting identified opportunities in coordination with other donor programs. The objective of the Mission's SME strategy will be to accelerate SME expansion in the more dynamic sectors of the economy where there are clear opportunities for growth in employment, income and business investment in both the near and mid term.

II. Background:

In response to the positive changes in the Croatian government in early 2000, there was a significant increase in USG assistance levels for this year. USAID quickly mobilized assessment teams to examine the banking and agricultural sectors; the GOC fiscal situation; capital markets; and the status of the judicial system and commercial laws impacting on investment. Based on the assessments, shorter-term (generally through the end of calendar year 2000) technical assistance efforts were contracted for and mobilized in several areas. These included GOC fiscal reform, asset management and privatization, bank supervision, and commercial law reform. Longer-term contracts have now been put in place to provide a long term economic advisor to the Deputy Prime Minister and for fiscal reform efforts in the Ministry of Finance. Longer-term contracts for assistance in commercial law, pension reform, and privatization/asset management should be in place by January of 2001. A program of assistance in energy sector privatization/power markets development is also under consideration.

The new GOC has taken some positive steps towards addressing some of the difficult political and economic problems left by the prior government, but the major work lies ahead. Already high levels of unemployment (in excess of 20%) will continue to rise as large numbers of bankrupt state-owned enterprises and private sector companies are restructured and/or close their doors. GOC plans to move forward with an aggressive privatization program will add to the unemployment problem as redundant workers are laid off. The government's fiscal situation will worsen when the basically insolvent pension fund is brought on-budget in January 2001. The large outstanding debts owed by the pension fund will compound the already serious payment arrears the GOC faces in other areas.

The picture on the macroeconomic side is much brighter. Tight fiscal and monetary policies have resulted in stable exchange rates and low inflation. GDP growth is returning to a projected 3% in 2000 after falling slightly in 1999. Tourism, the most important sector and a large source of foreign exchange earnings, was up sharply this season. The banking sector seems to be returning to good health after several of the larger banks failed and were sold to foreign investors over the last two years. Croatia has one of the most liberal trade regimes in the CEE, and is actively seeking foreign direct investment to help restructure industry and create new jobs.

The current 6 party ruling coalition came to power united more in opposition to the former government than united in a common vision for Croatia's future. The result has been some public missteps and a lack of a public, coherent and unified policy structure. It is hoped that the coalition is able to pull together and follow through on the positive reform agenda it has espoused

III. Approach/Deliverables:

Given the fact that USAID/Zagreb has not had a nationwide, comprehensive SME program previously (the Mission has had some direct small-scale business/agriculture assistance confined to the refugee returnee population in the war-affected areas), a good deal of new groundwork will be required. The team should begin with a review of the relevant assessment reports, which will be forwarded electronically from the Mission. These include:

- Commercial Law Assessment
- Financial Sector Assessment
- Agricultural Sector Assessment
- Information Communication Technology Assessment (currently underway)
- Capital Markets Assessment

The assessment team's report should include a review of the overall legal/regulatory/policy environment for business development. The recent commercial law assessment report provides a strong basis for this review, and a pending FIAS "Administrative Barriers to Investment" study should provide a very detailed look at the concrete roadblocks to private sector investment from business entry through exit. The FIAS study was supposed to be released in August but has been delayed. It should be ready in time for review by this assessment team.

Beyond the legal/regulatory/policy environment constraints to SME development, the assessment report should address constraints such as lack of market information, knowledge or access; lack of market development skills; lack of access to credit and equity capital; poor infrastructure; business support services; and inappropriate technology.

The assessment should also identify those sectors that are the most promising for SME growth and provide recommendations for possible targeted interventions to those sectors with particular emphasis on export oriented sectors. Tourism currently is the largest contributing sector to GDP and FX earnings, and has great potential for expansion just to return to pre-war levels. Large numbers of state-owned tourism facilities on the coast are slated for rapid privatization. The agriculture and information technology sectors also merit particular attention.

The team's assessment of Croatia's current and potential competitive advantages or impediments to the country's competitiveness with respect to global and regional markets should also be discussed. If appropriate, the team should suggest approaches the Mission might take to working with Croatian stakeholders to improve the country's competitive position.

A draft schedule of meetings for the team is attached. The assessment team will work directly with Michael Greene and Damir Novinic of the Mission's economic team. The team will maintain constant communications with key mission staff as their findings and recommendations are developed, and key findings/recommendations will be vetted before inclusion in the draft report. The team will deliver a draft report and outbrief to the Mission Director on their findings before departing post.

ATTACHMENT 4

A Proposed General Outline for USAID Assessment Team SOW for Croatia SME Development Activity

1- Background on the economy

Background on economy, including data on: Growth; Investment; Employment; Private sector development (with sub-national data); Privatization; Size-Class data; Social indicators; Training and education indicators.

2- Entrepreneurship and enterprise development

2.1. Introduction to the contribution to date of Entrepreneurship and enterprise development to the economy, plus the historical, cultural, social, political and economic context.

2.2. Statistics, sectoral progress, level of business culture, etc

2.3. The main current obstacles to Entrepreneurship and enterprise Development (Financial sector, lack of support, administrative barriers, corruption, taxation, etc.)

2.4. Main current opportunities for enterprise development on offer.

3- Policies to support Entrepreneurship and enterprise development

3.1. The overall policy framework – the objectives (political, economic and social) and institutions of Entrepreneurship and enterprise development policy (Ministries, agencies, and other bodies; regulations, procedures, custom and practice, etc)

3.2. General policy responses to foster the business environment in order to promote Entrepreneurship and enterprise development. SME policy broken down by Ministry, Ministerial programs, interministerial co-ordination, resources allocated, governance issues reform aiming at improving the climate for private sector development (such as regulatory reform, administrative burdens, integrity, corruption, capacity building, and policy coherence).

3.3. Micro-policy responses, including both domestic and international agency programs of support (finance, institutions, training, sub-contracting programs, etc). Developing the role of local and regional government in promoting Entrepreneurship and enterprise development. The social dimension of policy formulation. - How to boost entrepreneurial culture, corruption and integrity in business issues, Women in business, Self help organizations in business, Ethnic issues. Equality and fairness issues.

3.4 How the present policies and instruments meet the accepted best practice benchmarks and summary conclusions on existing policies, institutions and support programs

3.5 Competitiveness: policy and practice

4- Policy Evaluation.

4.1. Adjustments to, and new, policies needed to promote the business environment in which small enterprise development takes.

4.2. Adjustments to, and new, policies and institutional vehicles needed to promote enterprise development and competitiveness.

5- Specific policy recommendations

Suggested recommendations:

- Public sector governance (central, regional and local government) reform issues (i.e., removing the barriers to business)
- Institutional capacity-building measures (e.g., institutions addressing technical, financial and advisory needs).
- Strengthening the social fabric through enterprise development (e.g., support for minority businesses, institution-building in disadvantaged communities, co-operative development)
- Strategic policy interventions, including sectoral, cluster, export-oriented, FDI-leveraging, etc
- Improvements in competitiveness

6- Conclusions and Opportunities for USAID Intervention and Action plan

- What is the niche for USAID?
- USAID existing programs, successes, failures, future expectations
- USAID capacity to intervene in various TA activities
- Other donor's activities
- Success stories both in terms of enterprises as in terms of support programs from the country
- Relevant examples of policies in other countries.

ATTACHMENT 5

MAP OF CROATIA

